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TRANSNATIONAL LAW OF THE OVER-THE-COUNTER DERIVATIVES MARKET

A STUDY ON THE INTERACTIONS BETWEEN FINANCE AND LAW

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DOCTORAL DISSERTATION

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To my wife and my son

ABSTRACT

The emergence and rapid evolution of the over-the-counter (OTC) derivatives market in the early 1980s revolutionized the whole landscape of finance. OTC derivatives are financial products that are *transnational* in their nature. These products do not follow any jurisdictional lines nor theoretical boundaries focusing on state-made law. They transcend them. The central argument of this research is that legal scholarship requires a legal theoretical approach capable of recognizing *private normativity* and that accepts that it is not only nation states and organizations that derive their powers from states that can produce *law*. Transnational method allows the observer to acknowledge the transnational elements of finance and then set them into a legal theoretical structure.

This research retells the evolution of the OTC derivatives market through the application of transnational method. Instead of building a narrative emphasizing the de- and reregulation policies and politics, the research focuses on early beginnings of the largest capital market in the world, the so-called eurobond market of the 1960s. Through legal innovation, this market developed its own transnational rules. In the 1980s, this market became integrated with the rapidly growing market for swaps, a type of OTC derivative. Seeing the demand for contractual standardization, a handful of financial institutions became organized through a trade organization today known as the International Swaps and Derivatives Association, Inc. (ISDA). The main product of ISDA, the ISDA Master Agreement architecture, had become by far the most used standard agreement in the OTC derivatives market already before the 1990s. Post financial crisis of 2008, this transnational contract still holds a central position in a very different regulatory environment than that of the 1980s.

Transnational method identifies the supply and demand for financial and legal innovation, and the facilitative role that nation states and international organizations can play in enhancing private normativity and the transnationalization of law. The results that transnational method tells are first and foremost descriptive. The application of transnational method requires a functional, rather than formal, understanding of 'law' because this allows private normativity to be recognized and its ontology properly understood.

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In Asikkala, Finland
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Antti P Salonen

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ABBREVIATIONS

BCBS	Basel Committee on Banking Supervision
BRRD	Bank Recovery and Resolution Directive
CCP	Central counterparty
CDS	Credit default swap
CFTC	Commodity Futures Trading Commission
CSD	Central securities depository; or
CSD	Credit Support Deed
EBA	European Banking Authority
ECB	European Central Bank
EEA	European Economic Area
EMIR	European Market Infrastructure Regulation
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
FCD	Financial Collateral Directive
FSA	Financial Services Authority
FSB	Financial Stability Board
GFC	Global Financial Crisis
IM	Initial margin
ISDA	International Swaps and Derivatives Association
IOSCO	International Organization of Securities Commissions
MA	Master Agreement
OTC	Over-the-counter
SEC	Securities Exchange Commission
VM	Variation margin

1. GENERAL REMARKS ON TRANSNATIONAL LAW

1.1 INTRODUCTION

Standardized financial contracts that 'are used across the globe' are the manifestation of the modern *lex mercatoria* of finance.[1] The ISDA Master Agreement, a standardized contract architecture published by a private trade organization, International Swaps and Derivatives Association, Inc. (ISDA) is a manifestation of the *lex mercatoria* of the over-the-counter derivatives (OTC) market.[2] The OTC derivatives market is not only one of the largest if not the largest financial market in the world, but it is interlinked to all other areas of finance. The market is based on derivative structures that are 'ancient ideas' that have existed for centuries.[3] Both public and private entities use the ISDA Master Agreement, from nation states to transnational financial institutions and transnational corporations. A contractual term and a particular type of set-off mechanism that came to be known as *bilateral close-out netting* was first introduced in the early version of the ISDA Master Agreement architecture in the 1980s. In a short period of time, this contractual clause became 'an integral indeed a central part of the standardized industry documentation for OTC derivatives and of the *lex mercatoria* of the financial markets in general'.[4]

Before the 1980s, bilateral close-out netting did not exist. It has transnational, private origins. Through international financial regulation, the use of master agreement architecture in the OTC derivatives market became virtually mandatory for financial instutions and, through this, also for the end-user corporations. The enforceability of bilateral close-out netting in insolvency situations eventually became explicitly recognized in many key jurisdictions, including the US, the UK, and the EU. The enforceability of bilateral close-out netting evolved from simple market practice into a public policy requirement and a debated cornerstone of modern finance.

The primary purpose of this research is to capture the interaction between transnational law of the OTC derivatives market and state-made law and regulation by approaching the phenomena from a legal theoretical perspective. Essentially, this

1 Roy Goode, Herbert Kronke, Ewan McKendrick, *Transnational Commercial Law, Texts, Cases and Materials* (2nd edition, OUP 2015) para 15.14.

2 Francesca C Villata, 'Remarks on the 2012 Greek sovereign debt restructuring: between choice-of-law agreements and new EU rules on derivative instruments' Rivista di diritto internazionale privato e processuale – N. 2–2013, 325, 348.

3 Alastair Hudson, *The Law on Financial Derivatives* (5th edition, Sweet & Maxwell 2012) paras 1–08–10.

4 Marcel Peeters, 'On Close-out Netting' in Thomas Keijser (ed), *Transnational Securities Law* (OUP 2014) paras 3.01–3.05.

research seeks to anwer the question ‘what transnational law is?’ and how to study it. In this analysis, two interconnected markets, the so-called “eurobond market”, which paved the way for the OTC derivatives market already in the 1960s, and the OTC derivatives market serve as a medium in answering this question. Essentially, these markets transcend the borders of state law and are not easily put into the more traditional categories of law or legal theories that focus on state-made law. In transnational law, acknowledging and understanding private normativity and the evolutionary nature of law are key. Quite tellingly, while not referring to or discussing anything about legal theory or transnational law, *Schuyler Henderson* describes the OTC derivatives market as being ‘everywhere and nowhere’ as it affects every other financial market but has no fixed location. These markets are ‘very large, very important and little understood’ and there were few rules regarding how OTC derivatives could be structured and used prior to 2010.[5]

1.2 TRANSNATIONAL METHOD

Transnational law has a rich scholarly tradition which offers a legal theoretical construct consisting of autonomously, spontaneously, and privately created norms that form a transnational *legal* order. Transnational method that studies transnational law as a distinct research area dates at least to the 1950s and has an ever-growing body of interest also in contemporary legal theoretical studies. Similar observations about the evolutionary nature of private normativity have been made outside the more-traditional transnational legal studies. According to *Simon Deakin,* contemporary research on financial regulation tells us that both state law and markets coevolve, that they are both adaptive systems and, although interrelated, the state has its limits in reshaping market outcomes. From a public policy perspective, an ‘explicitly evolutionary conception of the law-finance relation’ should be the next step. [6]

Philip Jessup is a primer for much of the literature on transnational law. However, the evolutionary aspect inherent in his definition is perhaps not known by many. This research is much about the evolutionary aspects of law and putting these aspects into a legal theoretical framework in this tradition. In his 1956 response to Professor *Alf Ross*, who had in 1947 attempted to introduce a new concept of ‘private international law’, Jessup wrote:

5 Schuyler Henderson, *Henderson on Derivatives* (2nd edition, LexisNexis 2010) paras 1.1, 2.1.

6 Simon Deakin, ‘The Evolution of Theory & Method in Law & Finance’ in Niamh Moloney, Eilís Ferran, Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (CUP 2013) 25–28, 37.

> I shall use, instead of 'international law,' the term 'transnational law' to include all law which regulates actions or events that transcend national frontiers. Both public and private international law are included, as are other rules which do not wholly fit into such standard categories.[7]

Enforceable, binding contract is law that regulates private actions between contracting parties and events that demonstrably transcend national frontiers. Since such a phenomenon was not easily placed into existing categories of law, they were referred to being transnational in their ontology. Following the creation of the Columbia Journal of Transnational Law in 1961, Jessup went on to describe the term 'transnational' as a widely used term to describe legal problems that transcend national frontiers and for which existing legal thinking is unable to identify let alone be able to give answers to. The core of transnational law is 'the interrelationships between the multiple factors which contribute to *the unending processes of legal evolution*'.[8] It was already during that time, when the same concept of *spontaneous formation* of law, private regulation through contract, and the alike sharing the same notion of non-national law saw the light in academic legal discourse.[9] Going back further in history, at the end of the 19th century, *Oliver Wendell Holmes* described the law as being the outcome of spontaneous growth.[10]

The definition introduced by Jessup has been criticized for being too broad since its introduction.[11] If that critique is combined with the claim that transnational law lacks legitimacy, for one reason or another, it can 'deprive us of the capacity to define transnational law *in abstracto*, which in turn makes it impossible to map out actual phenomena as transnational law in practice'.[12] This is a problem in legal theory, which is addressed in Chapter 2.

Moving to the early 1980s, the concept of *legal pluralism* was introduced as a descriptive theory of law that challenged legal centralism of legal positivism

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7 Philipp Jessup, *Transnational Law* (Yale University Press 1956) 1.

8 Philip Jessup, 'The Concept of Transnational Law: An Introduction' (1963) 3 Colum. J. Transnat'l L. 1, 1–2 (emphasis added).

9 Klaus Peter Berger, 'The new law merchant and the global market: a 21st century view of transnational commercial law' (2000) 3 Int.A.L.R. 91.

10 Oliver Wendell Holmes, 'The Path of the Law' (1997) 110 Harv.L. Rev 991, 1000:

> The development of our law has gone on for nearly a thousand years, like the development of a plant, each generation taking the inevitable next step, mind, like matter, simply obeying a law of spontaneous growth.

11 FA Mann, 'The Proper Law of Contracts Concluded by International Persons' (1959) 35 Brit. Y. B. Int'l L. 34, n 2:

> The term [transnational law] is not unattractive, but it must be doubted whether there is any advantage in advocating transnational law, unless the scope of its application and the method of ascertaining it are explained with precision. Only when this is done will it be possible to say whether and to what extent the idea of a 'transnational law' is in any way different from and superior to traditional legal conceptions.

12 Matej Avbelj, *The European Union under Transnational Law – A Pluralist Appraisal* (Hart Publishing 2018) 9.

and its ideological groundings. In legal centralism, other normative orderings are subordinate to the exclusive law of the state, whereas legal pluralism challenged the exclusiviness aspect by describing how more than one *legal* order can exist in the same social field at the same time.[13] This academic notion was made over twenty years after the largest capital market in the world, the so-called eurobond market, had come into existence with its own transnational rules, transnational actors from corporations to financial institutions, and private regulatory mechanisms operating on a transnational plane discussed further in Chapter 3. The legal and regulatory framework of the 1960s and early 1970s was not open to cross-border capital movements. As counterintuitive as it may sound, the evidence indicates that this was also an era of financial, legal, and technological innovation that interconnected the global financial markets. This phenomen transcended virtually all state boundaries long before the era of de- and reregulation characteristic of the 1980s. The history of eurobonds and the emergence of modern capital markets in the early 1960s needs to be revisited before assessing the emergence of the OTC derivatives markets in the 1980s because the latter was founded on the former through swaps, a financial product that further revolutionized the financial markets and rendered national exchange controls on capital flows more or less meaningless. This revolution is described and discussed in Chapter 5 through the lens of *transnational contracts* and their evolution.

Transnational method allows transnational law to be conceptualized. An established legal theoretical construct exists, which defines transnational law in the abstract and which is used in this research.[14] Individuals engaging in repeated interactions can create normative orders that are unplanned and a creation of spontaneous action.[15] In practical terms, transnational actors exist and, through repeated interactions, they create norms and rules recognizable not only by their respective private business communities that engage in these interactions, but also by outside observers. These interactions produce material and observable artefacts, transnational contracts. One of these is the ISDA Master Agreement architecture, a creation of private market participants that has evolved through time since its beginning in the mid-1980s towards universally recognized and criticized standard in the OTC derivatives market to date.[16] By using legal theoretical method, this

13 John Griffiths, 'What is legal pluralism?' (1986) 24 J Legal Plur 1.

14 JH Dalhuisen, 'Legal Orders and Their Manifestation: The Operation of the International Commercial and Financial Legal Order and Its Lex Mercatoria' (2006) 24(1) Berk J Intl 129, 180–81.

15 Jan M Smits, 'European Private Law: A Plea for a Spontaneous Legal Order' in Deirdre M Curtin, Andre Klip, Jan Smits, Joseph A McCahery (eds), *European integration and law; Four Contributions on the Interplay between European Integration and European and National Law* (Intersentia 2006) 55. In economics, Yong Tao, 'Spontaneous economic order' (2016) 26 J Evol Econ 467, concluding that '[i] f a competitive economy is sufficiently fair and free, an unplanned economic order will spontaneously emerge' 496.

16 Tony Porter, 'Transnational private regulation and the changing media of rules' (2012) 13 German L.J. 1508, 1509.

research attempts to capture the ontology of this particular transnational contract. First, it is placed into a normative structure of transnational law in Chapter 2, and then investigated in detail in Chapters 4 and 5. Before analyzing transnational contracts, one needs to be familiar with the idea of transnationalisation of law. This is the purpose of Chapter 3.

ISDA Master Agreement, as a manifestation of transnational law, has demonstrably had a profound influence on court praxis and vice versa especially in English case-law, state laws, and financial regulations across various jurisdictions and on a transnational plane. It is not 'only' a transnational contract but a form of *private regulatory mechanism* through which market participants can regulate privately the action or inaction of their respective counterparties of the transactions they make. The OTC derivatives market became subject to extensive public financial regulation in the aftermath of the global financial crisis of 2008. Chapter 6 summarizes the critical observations made concerning top-down financial regulation and pushes forward the question what transgovernmental regulators are, what do they do and why.

Private rules may spontaneously emerge or be intentionally designed. The question of whether private rules can be qualified as transnational *law*, and if so to what extent, leads to an endless scholarly discussion and debate. This has been especially prevalent in legal research concerning international arbitration, a field that has attracted much discussion on the ontology of transnational law and modern lex mercatoria in which it is acknowledged that market participants create market practices which lead to the formation of private rules that, in turn, the market participants start to interpret and apply themselves. In this research area, *Thomas Schultz* has summarized:

> Calling something law has profound consequences (...) A definition of law could possibly extend so far as to include every possible social norm, or be so restrictive as to regard as laws only highly complex public regimes approved by thinkers of the liberal-democratic tradition. In the sand between these two rocks we shall draw a line.[17]

In this research, private norms in the form of contracts qualify as transnational law if state courts enforce them. In other words, enforceable contracts are law absent evidence to the contrary. They often qualify as law in the eyes of the state (even explicitly as discussed in subchapter 2.2) but parties to a contract cannot override local public policy requirements or create obligations for third parties. Put simply for this introduction, for example, a state court applying national law will

17 Thomas Schultz, *Transnational Legality. Stateless Law and International Arbitration* (OUP 2014) 8.

not enforce a contract for murder, nor validate a marriage between an adult and a minor. Enforcing such contracts would go against public policy of protecting life and minors, respectively. A state court will also not enforce a financial contract if a party to transaction lacked the authority to enter into a binding financial contract. In practice, as is discussed in Chapter 5, this can be the case even if such a court ruling would render a whole segment of over-the-counter derivatives transactions, worth hundreds of millions of pounds sterling, void overnight. Nor will a court enforce a contract that might favour one group of creditors over others if the debtor becomes insolvent since it would be unfair against the other creditors. It is a public policy choice not to give enforceability to some types of contracts. Enforceability is key in determining what type of norm qualifies as 'law'. Again, put simply, norms of an organized crime syndicate, regardless of how observable for outsiders and obeyed these norms might be within such community, will not be enforceable. Contrary to this, much of this research is about the transformation of national black-letter insolvency laws through international cooperation as to facilitate over-the-counter derivatives trading which might, in the ordinary application of insolvency laws, go against prevailing public policy choices. The interactions between transnational law and state-made law are used as a medium to explain what transnational law is and what transnationalisation processes mean in finance.

The legal scholars of the 1960s were able to identify and conceptualize the interactions in business and how they produce their own rules. They understood that in order to have a legal angle to something that demonstrably transcends the state, it is necessary to have a functional rather than formal understanding as to what constitutes law. If for nothing else, this conceptual choice could bring private normativity for legal scholars to study. Transnational law, in the form of transnational contracts is spontaneous and autonomous as to its emergence, existence, and evolution. Ttransnational method is a conceptualizing tool that is descriptive or epistemic, rather than normative in its application, even if the method uses the word 'law' liberally. The identification of verifiable facts and conceptualizing and placing them in a transnational legal order is not to be read as an outright normative statement. It is easy to agree with *Matej Avbelj* in that what transnational law means is ultimately a conceptual choice,[18] with *César Arjona* and others in that '[i]t is always worthwhile to try to find the best and most precise description of world realities without actually implying a positive or negative normative conclusion',[19] and with

18 Avbelj (n 12) 9.

19 César Arjona, Joshua Anderson, François Meier, Sierra Robart, 'What law for transnational legal education? A cooperative view of an introductory course to transnational law and governance' (2015) 6 TLT 253, 278.

Jan Dalhuisen in that '[i]n *legal scholarship* all is free', and that experimentalism in legal research has inherent value.[20]

1.3 TYPOLOGY OF TRANSNATIONAL LAW

Finance interacts with legislation and financial regulation, and the theory of transnational law helps to identify these interactions by conceptualizing them. Put into a legal theoretical context, transnational law can be conceptualized in many forms, including both wider and a narrower meaning. Transnational law in its wider meaning refers to public, administrative, and private transnational law. It is useful to repeat the typology drawn by Avbelj in order to summarize the main research areas in this field. The following table serves the purpose of placing this research somewhere between administrative and private transnational law. These regimes interact, and in this research, this is illustrated through the interactions between a trade organization, ISDA, and international financial regulators.

Transnational law[21]		
Public	**Administrative**	**Private**
International law	Public	New *lex mercatoria*
Regional supranational law	Hybrid	Transnational corporate law
Private international law	Private	
Transnational human rights regimes		

In this typology, this research is about private transnational law. It definitely is not *public transnational law* which views transnational law as something where states hold power over the transnational law-making processes. This definition encompasses any laws whose effects *extend* beyond the state but which are still *exclusively* created by public entities. In other words, research made in this area may have a wholly differing view of what is transnational law since there is no room for the very concept of private normativity. It is a problematic approach not only

20 Jan Dalhuisen, *Dalhuisen on Transnational Comparative, Commercial, Financial and Trade Law, The Transnationalisation of Commercial and Financial Law and of Commercial, Financial and Investment Dispute Resolution. The New Lex Mercatoria and its Sources. Volume 1* (6th edition, Hart Publishing 2016) 135–36.

21 Avbelj (n 12) 10.

because it deviates significantly from existing research on transnational law and may add only to confusion, as argued in Chapter 2, but also because much of what is seemingly created by public entities originates de facto from private market activity.

Administrative transnational law can be characterized as something of an evolutionary step from public transnational law since it identifies the existence and role of private actors, their interaction with public actors, and the normative power they hold.[22] Under this categorization, private actors, such as non-governmental organizations, can involve and influence the decision-making and the decision-making procedures of states. Without a doubt, private trade organizations do this. But again, this categorization does not place private normativity at the forefront of academic inquiry. In contrast, *private administrative transnational law* recognized private decision-making processes from which public entities are absent but which nevertheless 'regulate through acceptance the collective practices of numerous entities in designated sectors without their prior assent to these rules'.[23] This definition captures what trade organizations in finance do when they standardize contracts. Bilateral close-out netting is a collective practice in the OTC derivatives markets and its use is virtually mandatory for financial institutions, and indirectly through this, to entities wishing to enter into OTC derivative transactions with the former.

A characteristic feature of *transnational law* is that it is contract- and practice-based and that it involves an evolutionary or spontaneous element as to its emergence, application and codification.[24] While often labeled as something purely technical, functional, and 'apolitical', transnational private law can be viewed as a 'central and crucial mediator of domestic and global political/legal orders in that it enables the extraterritorial application of national laws as well as the domestic application of transnational commercial law'.[25] In this research, private transnational law is referred to as transnational law since this categorization is in line with the historical roots and existing studies of the whole concept.

Transnationalisation of law is understood along the lines of *Jan Dalhuisen*:

> [a] process and way of thinking characterized by the operation of autonomous nonstatist sources of law subject to a hierarchy established in a separate and autonomous legal order (the transnational commercial and financial legal order) with its own public policy concepts and

22 ibid.

23 ibid 14–15.

24 ibid 15–17.

25 Claire Cutler, *Private Power and Global Authority Transnational Merchant Law in the Global Political Economy* (CUP 2003) 4.

> requirements, which, depending on the facts of the case, compete with relevant domestic legal orders.[26]

Bilateral close-out netting derives from a nonstatist source of law, a transnational contract. In addition to this, the use of bilateral close-out netting is a public policy requirement in financial regulation. The process that leads to transnationalisation of law can be identified by following evidence. Contract is a nonstatist source of law and transnational financial contracts do operate in a somewhat autonomous legal order with their own public policy concepts, such as financial stability. To draw an analogy, not unlike transnational law of finance, transnational law of professional sports is:

> [a] world-apart, self-regulated by its own rules, and through its own politicial processes: a private society that sets its own guiding principles in apparent isolation of municipal legal systems. [27]

1.4 ETHICAL CONSIDERATIONS

It has become a truism to associate derivatives to the global financial crisis of 2008 the economic and regulatory repercussions of which are felt today. As summarized by *Adam J Levitin*, '[w]hat the financial crisis has wrought remains to be seen, [...] it is spurring a major and much-needed rethinking about law, institutions, and society'.[28] Calls for more and sometimes better financial regulation are common after any financial crisis. This discourse seems to be stuck in a repetitive loop.[29] Transnational law might bring forward a nuanced understanding how finance and law interact for lawyers. The indirect contribution to ethics stems from research that might offer some guidance as to how finance and its transnational laws, the laws of states and regulation interact.

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26 Dalhuisen (n 20) 7.

27 Antoine Duvall, 'Lex Sportiva: A Playground for Transnational Law' (2013) 19 ELJ 822, 827–28; Jo Braithwaite, 'Law After Lehmans' LSE Law, Society and Economy Working Papers 11/2014 London School of Economics and Political Science Law Department. Braithwaite describes the lasting legacy of the largest bankruptcy in US history, the fall of Lehman Brothers Holdings Inc. on 15 September 2008 and how the court interpretations of the ISDA Master Agreement can have far reaching impact across the financial markets far beyond the litigants and creditors concerned.

28 Adam J Levitin, 'The Crisis without a Face: Emerging Narratives of the Financial Crisis' (2009) 63 U. Miami L. Rev. 999, 1010.

29 James R Barth, Gerard Caprio Jr, Ross Levine, *Guardians of Finance – Making Regulators Work for Us* (The MIT Press 2012) 147–57.

Joanna Gray, among many others, have put forward the question whether lawyers should pay regarding the stability of the financial system by not acting only in compliance with all applicable laws and regulations but also beyond it. Lawyers can be seen as the de facto 'legal engineers' of many financial products that contributed to the global financial crisis of 2008. Gray's answer is that yes, they should pay more attention.[30] *David Kershaw* and *Richard Moorhead* have similarly put forward the question of whether transactional lawyers should bear responsibility when their competent actions facilitate unlawful activity by their client? Their answer is also yes, they should bear responsibility. The policy measure suggested is that the Solicitors Regulatory Authority, the regulatory body for solicitors in England and Wales, should include in its Handbook a provision requiring lawyers not to assist clients if it creates a 'foreseeable likelihood' of breach of criminal law, civil law, or regulation.[31] The evidence from the eurobond market suggests that market participants used all the legal efforts in ensuring that every aspect of trading is in compliant with any actual and even possibly applicable state laws. Market participants, both public and private, self-regulated the market and identified the potential legal risks. The same applies to the ISDA Master Agreement architecture. The evidence gathered tell that its designers were conscious of the national legal boundaries and their possible impact on OTC derivatives transactions from the perspective of criminal law, civil law, and financial regulation.

As summarized by *James R Barth* and others, financial innovation can bring forth progress and it can bring calamity, it is always in state of flux, it is part of long-run economic progress, and limiting it unnecessarily will have major negative consequences for economic growth. History demonstrates that technology, telecommunications, and medicine are all areas where corporations struggled to raise capital from commercial banks as they were, while potentially lucrative, still unable to cover loan payments and pay the salaries of their employees at the same time. Financial innovation and the creation of specialized investment banks helped to circumvent these problems by creating new types of finance unknown to traditional commercial banks. Financial innovation can boost productivity, foster specialization, and lower transaction costs. It is equally true that financial innovation can be abused in a socially harmful way. One thing the regulators can do is not create regulations that *encourage* the creation of *harmful* financial innovation.[32]

According to *Avinash Persaud*, it is extremely difficult and possibly even futile to try to trace the blame to any acting individuals or find accountability or grounds

30 Joanna Gray, 'Lawyers and systemic risk in finance: could (and should) the legal profession contribute to macroprudential regulation?' (2016) 19(1) Legal Ethics 122.

31 David Kershaw, Richard Moorhead, 'Consequential Responsibility for Client Wrongs: Lehman Brothers and the Regulation of the Legal Profession' (2013) 76(1) MLR 26.

32 Barth and others (n 29) 45–49.

for restitution for even illegal activities for the same for any financial turmoil as morally wrong as it may feel.[33] Similarly, *Steven L Schwartz* and *Lucy Chang* note that the risks and financial crises may be due to outdated customs. Criminalizing such custom let alone establishing a criminal intent in individual cases would be difficult and even questionable given that the effects, positive or negative, of a certain type of activity are unforeseeable.[34] For example, market manipulation is a criminal offence and following the global financial crisis, the UK introduced new regulations making it a criminal offence for senior managers to cause a financial institution to fail. The intention of the changes can be seen as well-intentioned in the hope that they would curb privatized gains at the expense of the taxpayers. In practice, however, it can prove to be very hard to uncover a potential offence, let alone for an investigation leading to a conviction, due to the high threshold of certainty that must be met in any criminal proceedings. In finance, the obstacle is only exacerbated in a boom phase where individuals turn into a horde of people with a tendency to underestimate risks and especially the bust phase when there are many forces at play other than the action of individual managers.[35]

The descriptive parts that indicated how to structure a transaction in a manner that renders laws and regulations meaningless are drawn from peer-reviewed legal journals, books written by the most eminent scholars and industry practitioners, and from publicly available industry publications from the 1960s onwards. To the author's understanding, none of the cases of 'financial engineering', 'legal innovation', and 'arbitrage', and many other concepts that may generally raise suspicion among legal scholars, referred to in this research were in breach of any criminal law, civil law, or financial regulation. It might be that some were, but it is not the purpose of this research to investigate such occurrences. There is a multitude of existing research on these wrongdoings already. All the innovations from eurobonds to OTC derivatives were originally private constructs but their use was eventually encouraged by states and international organizations, even when it was risky from a legal standpoint to do so. In this legal environment, while still risky or perhaps even riskier than ever, market customs, practices, and transnational contracts evolved to something that is part of everyday financial transactions today. Transnational law does not mean advocation of one public policy over the other – unless one wishes to read it as such.

33 Avinash Persaud, *Reinventing Financial Regulation – A Blueprint for Overcoming Systemic Risk* (Apress 2015) 169–70; Martin Gelter, 'Risk-shifting through issuer liability and corporate monitoring' (2013) 14 EBOR 497, noting the insufficient incentives for deterrence in securities fraud and discussing possible ways of promoting enhanced ways of monitoring this risk.

34 Steven L Schwartz, Lucy Chang, 'The Custom-to-Failure Cycle' (2012) 62 Duke Law Journal, 767, 787–88.

35 Persaud (n 33) 163–70, concluding that '[t]he grim reality is that we must place our greatest hope of moderating the behavior that lies behind financial crashes in the reinvention of financial regulation'.

1.5 CONTENTS

Chapter 1 introduces the general concepts of transnational law and its evolutionary nature that derives from private normativity. Much research about transnational law and how since its inception transnational law has been about private normativity and law that does not originate from states. The argument is built futher in Chapter 2 that includes the theoretical foundations of the research. Transnational method is about acknowledging and identifying private normativity as a non-statist source of law that can be constructed in the form of a transnational legal order. Private normativity creates private regulatory mechanisms such as transnational contracts. As long as these private regulatory mechanisms do not violate local public policies reflected in national laws, the private rules they produce are generally enforceable and can be equated with state-enacted 'hard' law. The chapter includes a case-study on a transnational insolvency of a financial institution in the 1970s, which demonstrates how a transnational legal order can exist despite lacking state legislation and regulation on transnational insolvency. The same case study also demonstrates how this particular insolvency triggered the era of international financial regulation that would stimulate market behaviour, lead to financial engineering, and which would play an elemental role in the formation of the OTC derivatives market in the 1980s.

Chapter 3 revisits the pre-liberalization era on capital flows of the 1960s. This is because the transnationalisation of finance can be said to if not begun then rapidly accelerated at that time, about two decades before the emergence of the OTC derivatives market. Back then, the legal and regulatory environment was geared against cross-border capital flows. Public policies of states were prohibitive towards, or at the very least not facilitative for, cross-border capital movements. Yet, it was during this era when transnational prcosesses accelerated through the introduction of eurobonds, a type of debt security, and the eurodollar market, which gave rise to modern banking in an uncoordinated and unplanned manner. Transnational customary law ensued. In the 1980s, the eurobond market converged with the OTC derivatives market also in a process best described as being spontaneous in its development because no authority planned or could have planned or designed such a market.

Chapter 4 explains the nature of transnational contracts and how they form the modern lex mercatoria of finance through repeated interactions. Quite far from being secretive and unpenetrable for outsiders, these transnational contracts, private rules that market participants obey and interpret, have a long history of interacting with state laws, financial regulation, and national courts. The ISDA Master Agreement, by far the most used transnational contract in the OTC derivatives market, is governed by default either by English law or the laws of the state of New York and the jurisdiction English courts or the courts of the state of New York, respectively.

The reasons for the popularity of these jurisdictions are summarized. A case study describes how not even a major breakdown of the OTC derivatives trading under English law was not enough to deter market participants from choosing English law and English courts as their choice of law and jurisdiction, respectively. Chapter 4 also describes the regulatory environment of the early days of the OTC derivatives market and lays out simple examples of how the most common types of OTC derivatives are structured and how they can lead to the erosion of existing financial regulation without necessarily any formal act of deregulation by states.

Chapter 5 describes how the trade organization ISDA and the ISDA Master Agreement came into existence and why, as well as analyzes the emergence and the evolution of bilateral close-out netting. Originally a mere contractual term, it soon evolved into a mandatory regulatory requirement for transnational financial institutions and, through this requirement, also for transnational corporations engaging in OTC derivatives trading. The chapter also includes a case-study of transnational private regulatory regime that played a pivotal role in the debt crisis of 2012 involving the sovereign default of the Hellenic Republic on its debt and eventually the whole future of the Euro currency area. Chapter 6 includes a summary and critical analysis of the regulatory framework of the OTC derivatives market after the Global Financial Crisis (GFC) of 2008. A market once privately self-regulated through transnational contracts became regulated through transgovernmental cooperation. The regulatory framework has attracted much criticism in legal scholarship. Chapter 7 includes research findings and reflections on the research.

2. TRANSNATIONAL LAW OF FINANCE

2.1 TRANSNATIONAL LAW IS ABOUT INTERACTIONS BETWEEN PRIVATE AND PUBLIC

Transnational law is about private normativity and the notion that enforceable contracts are one source of law. Transnational method is the legal theory that acknowledges, emphasises, and conceptualizes private normativity. Transnational law is not revolutionary but complementary in its nature. Transnational law is not to contradict but to complete other viewpoints by offering a conceptual framework for private normativity that demonstrably transcends state boundaries. [1] As noted by *Jaakko Husa*, historical dimension is valuable in studies on legal globalization as well as modern lex mercatoria. However, one needs to be careful in drawing parallels between the past and the present.[2] Both in the past and in the present, market participants have relied and continue to rely on pre-existing public institutions. Private normative orders do not form independently from their surrounding societies.[3] Spontaneously-created law operates in a legal framework or other type of order.[4]

The existence of a purely independent, anational, spontaneous private legal order that would consist of a homogenous and universal merchant practice has been contested both in legal history as well as in contemporary legal research. An *independent* historical lex mercatoria applied uniformly in different merchant courts across Europe probably never existed during earlier times. There is evidence, however, of courts that could develop rules that were receptive to the needs of some merchants. Market participants have never operated independently in a transnational vacuum outside the reach of rulers, whether they were ancient kingdoms or modern nation states, but transnationalisation processes and private normativity are real. From the Maghribi traders of the Mediterranean in the 11th

1 In this research, 'state' refers generally to all institutions of the nation state, structures of cooperation under public international law, local supranational arrangements such as the European Union, and transgovernmental actors such as the G20, unless otherwise defined where the context so requires.

2 Jaakko Husa, *Advanced Introduction to Law and Globalisation* (Edward Elgar Publishing 2018) 78.

3 Amitai Aviram, 'Path Dependence in the Development of Private Ordering' (2014) Mich. St. L. Rev. 29.

4 Jan Dalhuisen, *Dalhuisen on Transnational Comparative, Commercial, Financial and Trade Law, The Transnationalisation of Commercial and Financial Law and of Commercial, Financial and Investment Dispute Resolution. The New Lex Mercatoria and its Sources. Volume 1* (6th edition, Hart Publishing 2016) 154.

century[5] to the Champagne fairs in the 12th and 13th century[6] and from the merchants in St. Ives of Medieval England,[7] to the eurobonds and OTC derivatives markets,[8] market participants and local rulers interact, and contract enforcement is left for public authorities.

Stephen E Sachs has concluded that no autonomous legal order consisting of merchant practice and mercantile customs has ever existed. Furthermore, attempts to regulate or even model international commerce with an argument supported by historical research suggesting otherwise simply has no historical foundation on which to build on. Rather than building on such romantic thesis, as Sachs coins it, evidence supports the view that '[l]ex mercatoria' was a general phrase for whatever law was appropriate to mercantile transactions, not necessarily a term for a specific body of principles actually applied to them'.[9] In contemporary finance, transnational contracts are a manifestation of the lex mercatoria and a source of law. [10]

Rulers can accommodate the desires and needs of merchants in addition to providing the necessary legal infrastructure for contract enforcement.[11] Different

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5 Jeremy Edwards, Sheilagh Ogilvie, 'Contract enforcement, institutions, and social capital: The Maghribi traders reappraised' (2012) 65(2) Economic History Review 421, noting, 439, 'Studies of Genoa, Florence, Germany, and the Netherlands thus all find merchants enforcing agency relations using reputation and informal sanctions within social networks', but making the observation that agreements are enforced by local rulers: 'In not a single case can private order enforcement of agency agreements through collective ostracism by a Maghribi coalition be observed in operation'.

6 Jeremy Edwards, Sheilagh Ogilvie, 'What lessons for economic development can we draw from the Champagne fairs?' (2012) 49 Explorations in Economic History 131, summarizing, 132:

> The evidence shows that contract-enforcement at the fairs did not take the form of private-order or corporative mechanisms, but was provided by public institutions. More generally, the success and decline of the Champagne fairs depended, for good or ill, on the policies adopted by the public authorities.

7 Stephen E Sachs, 'From St. Ives to Cyberspace: The Modern Distortion of the Medieval 'Law Merchant'' (2006) 21 Am.U.Int'l L.Rev. 685; on historical lex mercatoria generally, Leon E Trakman, 'A Plural Account of the Transnational Law Merchant' (2011) 2 TLT, 309, 313–14; Emily Kadens, 'Order within Law, Variety within Custom: The Character of the Medieval Merchant Law' (2004) 5 Chi. J. Int'l L. 39, noting, 48:

> To make their territory more attractive to astute merchants [...] lords early on granted merchants certain privileges that made commerce in their lands less precarious and more remunerative. These privileges included safe-conducts, trading rights and protections, and extraordinary remissions of normal laws; Leon E Trakman, 'The Evolution of the Law Merchant: Our Commercial Heritage' (1980) 12 J.Mar.L.& Com.

8 John Biggins, Colin Scott, 'Public-private relations in a transnational private regulatory regime: ISDA, the state and OTC derivatives market reform' (2012) 13 EBOR 309, discussing the very same topic as this research, although from a critical and prescriptive angle, 345:

> [t]he dominant transnational private regulatory body in the OTC derivatives markets, ISDA, has penetrated public legislative processes in order to enshrine safe harbours for OTC derivatives. These safe harbours have offered insulation from the full force of bankruptcy and gambling laws in the jurisdictions where they have been transposed to date.

9 Sachs (n 7) 788.

10 Roy Goode, Herbert Kronke, Ewan McKendrick, *Transnational Commercial Law, Texts, Cases and Materials* (2nd edition, OUP 2015) para 15.14; Francesca C Villata, 'Remarks on the 2012 Greek sovereign debt restructuring: between choice-of-law agreements and new EU rules on derivative instruments' (2013) 2 Rivista di diritto internazionale privato e processuale 325, 348.

11 Charles C Donahue, Jr, 'Medieval and Early Modern Lex Mercatoria: An Attempt at the Probatio Diabolica' (2004) 5 Chi. J. Int'l L. 21.

governmental, civil society, and economic actors interact and influence each other, and through this process, normative values are capable of becoming institutionalized on a transnational level.[12] Both common law and civil law provided a framework for private economic agents and contracts before modern notions of democracy.[13] Contracts and contracting practices, the historical lex mercatoria, and cross-border trade precede notions of sovereignty of the state.[14] Market participants act autonomously but not independently from their surrounding societies.

2.2 TRANSNATIONAL LAW AND LEGAL POSITIVISM

As noted by *Julie Dickson*, scholars advocating the use of the concept of transnational law may have a tendency to only cursorily refer to more traditional state-based legal theoretical models that focus on black-letter laws typically the outcome of an electoral process. Based on a somewhat shallow analysis, they deem the latter to be somehow outdated and inadequate in explaining ‘novel’ legal phenomena. At a closer inspection, many of the phenomena are not novel and they can be placed into positivist theoretical frameworks.[15] Newer entrants to scholarship may also claim that the established authors are misfocused on ‘systemic’ and ‘statist’ aspects of legal orders rendering their findings more or less useless for legal practice, and in any case, historically outmoded and too abstract.[16]

This research does not focus on a comparative analysis between different schools of thought. Even with this limitation, the research could be read as an any legal theory claiming that law-creation is exclusive to a state. For this reason, some comparative remarks need to be made in order to steer away from unnecessary legal theoretical clashes. The exclusion of non-state law is perhaps characteristic of the more classical branch of legal positivism but also of its modern version.[17] The paradigm that a centralized power in the 19th century was a nation state and in the 20th and 21st century has been more likely an international or supranational organization based on a treaty or a transgovernmental organization (discussed in subchapter 6.1.7) which all derive their powers from nation states. These are the only legitimate

12 Olaf Dilling, ‘From Compliance to Rulemaking: How Global Corporate Norms Emerge from Interplay with States and Stakeholders’ (2012) 13 German L.J. 381, 413–14.

13 Raouf Boucekkin, Fréderic Docquier, Fabien Ngendakuriyo, Henrik Schmigelow, ‘Contract Rules in Codes and Statutes: Easing Business Across the Cleavages of Legal Origins’ in Michèle Schmiegelow, Henrik Schmiegelow (eds), *Institutional Competition between Common Law and Civil Law – Theory and Policy* (Springer 2014) 44.

14 Husa (n 2) 78.

15 Julie Dickson, ‘Who’s afraid of transnational legal theory? Dangers and desiderata’ (2015) 6 TLT 565, 568–69, 574.

16 Guilherme Vasconcelos Vilaça, ‘Why teach legal theory today?” (2015) 16 German L.J. 781, 795–96.

17 Thomas Schultz, Transnational Legality. Stateless Law and International Arbitration (OUP 2014) 73–74.

source of law to which all other non-legal normative systems are subordinate to in a given territory, which remains paradigmatic. Attempts have been made to impose positivism and prescriptivism on transnational phenomena that simply do not fit into such categorizations.[18] The argument against the existence of transnational law is extensive not to mention the scepticism towards it.[19] As noted by *Richard E Epstein*, many who are against the existence of law merchant implicitly assume legal positivist theory. This research is not about resolving academic disputes, or in other words, '[w]e can let any reader choose the definition that he or she finds most congenial'.[20] It is the exclusivity aspect of legal positivism that transnational method challenges, not the supremacy of state laws over transnational law.

To think of transnationalisation as an autonomous and spontaneous legal order based on nonstatist sources of law, such as contracts, may collide with two classical legal positivist taboos. Originally probably summarized by *Gunther Teubner*[21] and further discussed by *Klaus Peter Berger*[22] these taboos are:

1. Private agreements cannot produce law without authorization or control by the states; and
2. Law cannot exist and cannot be applied beyond the realm of formal legal acts of a nation state without a 'global rule of recognition'.

In finance, state control comes largely from enforceability of contracts, and the contracting parties are largely free to choose which laws govern their contracts. They cannot, however, override local public policy requirements with contracts since then the contract risks becoming unenforceable. According to *Jan Dalhuisen*, there is no *grundnorm* à la Hans Kelsen nor is there a 'global rule of recognition' à la HLA Hart

18 Roderick A MacDonald, 'When Lenders Have Too Much Cash and Borrowers Have Too Little Law – The Emergence of Secured Transactions Transnational Legal Orders' in Terence C Halliday, Gregory Shaffer (eds), *Transnational Legal Orders* (CUP 2015) 114, 126.

19 David Charny, 'Illusions of a spontaneous order: 'norms' in contractual relationships' (1995–1996) 144 U. Pa. L. Rev. 1841.

20 Richard A Epstein, 'Reflections on the Historical Origins and Economic Structure of the Law Merchant' (2004) 5 Chicago Journal of International Law, 1, 3:

The persons who deny the independent existence of the Law Merchant are those who adopt, often implicitly, some version of the Austinian theory that marks law as a general command of the sovereign.

21 Gunther Teubner, 'Global Bukowina: Legal Pluralism in the World Society' in Gunther Teubner (ed) *Global Law Without a State* (Brookfield 1997) <https://ssrn.com/abstract=896478> accessed 1 June 2019; Gunther Teubner, 'Contracting Worlds: The Many Autonomies of Private Law' (2000) 9 Social and legal studies 399, 402. Teubner, while highly critical of the phenomena, does acknowledge the existence of lex mercatoria similarly as it is understood in this research:

'*Lex mercatoria* and other types of rules are basically law without the state. They are the product of a number of highly specialized governance regimes that develop autonomous political and legal orders independently from the law of the nation state and public international law.'

22 Klaus Peter Berger, 'The new law merchant and the global market: a 21st century view of transnational commercial law' (2000) 3 Int.A.L.R. 91.

in transnational law, but this poses no academic problem.[23] *Marcelo Dias Varella* describes the issue of transnational private norms from a traditional positivist viewpoint. Private norms such as contracts are an exercise or manifestation of private autonomy. The state remains central in producing law as well as in recognition and enforcement of private contracts. Since private norms emerge independently from states, and the state does not participate nor legitimate their creation, they do not qualify as law. The problem is that private autonomy, transnational private norms, and normativity exist regardless of their legal theoretical characterization, and thus 'The Kelsenian pyramid vision and Hart's rule of recognition do not explain contemporary legal phenomenon'.[24] Transnational law, both private normativity and legal theory studying private normativity, is an anomaly not easily explained nor fitted into positivist legal theoretical framework. At worst, attempts to impose positivist notions on transnational law may potentially lead to unnecessarily complicated explanations.[25] Transnational law, in its original meaning combining the idea of plan-less character and the evolution of law and legal pluralism, may offer an analytical framework to overcome such problems.

It is worth noting that many state laws equate private contract explicitly with law. Through this explicit authorization, contracts can produce law. For example, the codification of the Uniform Commercial Code (UCC) in the US was to allow a non-temporal creation of lex mercatoria by adding 'usage' in addition to 'custom'.[26] The eligibility for contracts being treated as 'customary law' requires that custom has developed over time, maybe immemorial in its use, and state recognition, in order to qualify as law. Adding 'usage', which did not impose such requirement, to the UCC allowed for a more spontaneous law creation to take place.[27] The French

23 JH Dalhuisen, 'Legal Orders and Their Manifestation: The Operation of the International Commercial and Financial Legal Order and Its Lex Mercatoria' (2006) 24(1) Berk J Intl 129, 168.

24 Marcelo Dias Varella, *Internationalization of Law Globalization, International Law and Complexity* (Springer-Verlag 2014) 252–53.

25 ibid 343:

> [t]he terms constitutionalization of international law, global democracy, participation, or representation still do not make much sense on a global scale, except when their meaning is substantially altered. Such a change of meaning to fit into a specific category is not justified, serving only to cause confusion.

26 UCC § 1–103

> (a) The Uniform Commercial Code must be liberally construed and applied to promote its underlying purposes and policies, which are: (1) to simplify, clarify, and modernize the law governing commercial transactions; (2) *to permit the continued expansion of commercial practices* through custom, *usage*, and agreement of the parties; and (3) to make uniform the law among the various jurisdictions.
>
> (b) Unless displaced by the particular provisions of the Uniform Commercial Code, *the principles of law and equity, including the law merchant* and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, and other validating or invalidating cause supplement its provisions. (emphasis added).

27 Cristián Gimenez Corte, 'Lex Mercatoria, International Arbitration and Independent Guarantees: Transnational Law and How Nation States Lost the Monopoly of Legitimate Enforcement' (2012) 3 TLT 345, 354–55.

Civil Code also equates explicitly private contracts with law.[28] In the EU, Rome I Regulation allows parties to incorporate 'by reference into their contract *a non-State body of law* or an international convention'.[29] While the existence of this non-State body of law is recognized in Rome I Regulation, such non-State body of law is still subject to state law including *lex contractus*, that is, the law applicable to the assessment of the rights and obligations arising from the contract, *lex fori*, thus the law of the court in which the action is brought, or the overriding mandatory provisions 'crucial by a country for safeguarding its public interests' under Article 9 of Rome I Regulation.[30]

Perhaps the characterization by *H Patrick Glenn* can capture the ontology of state as a legal and normative *tradition* based on accumulated information.[31] If the accumulated information suggests that state law is exclusive in its nature, there is no room for the conception that private contract is, or equals, law. Tradition prohibits it, if nothing else, and transnational contracts can facilitate compliance with local legislation reflecting these traditions as discussed in Chapter 4. Transnational legal studies, in turn, are, and have been since the 1960s familiar and comfortable with the idea of law originating from private sources, as demonstrated in Chapter 3, typically arising from contracts which can become transnationalised as further described in Chapter 5. Under certain circumstances, private actors can spontaneously or through intentional acts create laws that transcend state boundaries.[32] *Emmanuel Gaillard* suggested already in the mid-1990s that the expression of lex mercatoria is there to challenge the notion of exclusive state law:

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28 C. Civ. art. 1134 (74e ed. Petits Codes Dalloz 1974–75) (Fr.), 'Agreements lawfully entered into take the place of the law for those who have made them', English translation by Georges Rouhette, Anne Rouhette-Berton <https://legifrance.gouv.fr> accessed 1 June 2019.

29 Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations, OJ L 177, 4.7.2008, p. 6–16, recital (13) (emphasis added).

30 ibid Article 9; Villata (n 10) 348.

31 H Patrick Glenn, 'The State as Legal tradition' (2013) 2(4) C.J.I.C.L. 704, 708–14, describing transnational private regulation as 'often industry specific and industry-created, accepted by the state when it has no effective instruments of its own to deal effectively with the regulation required', 714, n 31; Ariel Meyerstein 'Transnational private financial regulation and sustainable development: an empirical assessment of the implementation of the equator principles' (2012–2013) 45 N.Y.U. J. Int'l L. & Pol. 487, claiming that private transnational regulations are 'direct responses to a series of missed opportunities by state actors to collectively create effective regimes of global international business regulation' 528.

32 Fabrizio Cafaggi, 'New Foundations of Transnational Private Regulation' (2011) 38 Journal of Law and Society 20, noting the important role of private trade associations such as ISDA as de facto regulators of their members; Fabrizio Cafaggi, 'The many features of transnational private rule-making: unexplored relationships between custom, jura mercatorum and global private regulation' (2014–2015) 36 U. Pa. J. Int'l L. 875, noting that such private regulators work in collaboration rather than in competition with public regulators, 890–92. This collaboration extends to public financial regulators who, in turn, can be claimed to have an impulse towards collaboration rather than domination, and who, in their former capacity, can facilitate already existing market practices, Annelise Riles, *Collateral knowledge: legal reasoning in the global financial markets* (University of Chicago 2011) 106–08.

> [B]y suggesting that it is necessary to have rules specifically tailored to the merchant community, the use of the expression lex mercatoria seems to imply that domestic legal systems are inadequate for the purposes of regulating international commercial relationships.[33]

The history of eurobonds, the rise of central securities depositories as well as the spontaneous development witnessed in the OTC derivatives market suggests that national laws can be inadequate in many respects from the viewpoint of transnational actors, including states and market participants. This is why there was a demand for rules specifically tailored to the transnational community, again, both public and private. The local legislation enacted in the 1960s and early 1970s in the Netherlands and Belgium imitated equity, a branch of English law, concept of trust but they were a unique creation borne out of supply and demand for a certain type of state law that would enhance legal certainty. Soon afterwards, technological advancement in the form of book-entry securities rendered these national laws outdated. What followed was the transnationalisation of book-entry securities into transnational customary law. Later on, in the 1980s, national insolvency laws were deemed inadequate by both private market participants as well as international regulators. They both saw a demand for ensuring the legal enforceability of bilateral close-out netting clauses used in the OTC derivatives market on public policy grounds as further discussed in Chapter 5.

2.3 LAW AND ECONOMICS ON PRIVATE NORMATIVITY

Law and economics tell that parallel normative networks co-exist, evolve, and interact; and that private norms may require but are not necessarily dependant on institutional support from a centralized power, were that power church, king, or parliament. Game theory acknowledges that repeated interaction between members of a small group can create a stable customary order. Within the sphere of this customary order, communication between its members serves as a governance scheme that also sets a sanctioning mechanism for non-compliance. The observations made by *Robert D Cooter* on the evolution and efficiency of social norms are as relevant as ever. Norms emerge from repeated interactions, and these norms can be imposed upon the members of a community. It is self-interest through which these norms are enforced privately. State courts can enforce these private norms,

33 Emmanuel Gaillard, 'Thirty Years of Lex Mercatoria: Towards the Selective Application of Transnational Rules' (1995) 10 ICSID Review 208, 209.

and through this, increase their efficiency. Backed by the coercive power of states, these social norms can be elevated to a level of law through courts.[34]

According to *Bryan H Druzin*, it is even possible, at least theoretically, to intentionally cultivate the process of private normativity and to create a customary order. This can be achieved through creating an environment where a small group can enter into repeated interactions.[35] The key element in understanding the creation of private norms lies in repeated interaction, in economic terms *equilibrium convention*, that leads to internalized belief that '[t]hese practice are considered necessary for social well-being and are treated as proper legal custom, often entering the legal system as primary sources of law' as summarized by *Francesco Parisi*.[36] Internationalization processes may not be yet fully-known.[37] Spontaneous development of private legal systems occurs in phases and the ability of such systems to regulate the behavior of its members takes time.[38] In order to be enforceable, customary rules evolved in trade need to fulfil a quantitative requirement and a qualitative element. It depends on the legal system on how long it takes for customary rules and usages to become enforceable. Generally, enforceability requires that customs and usages represent a socially desirable or necessary social conduct.[39] The history of eurobonds and bilateral close-out netting is much about the evolution and transformation of market practices into *transnational customary law*.

2.4 STATE ACTORS ARE MARKET PARTICIPANTS

Market participants of any given market surely recognize the existence of rules of conduct and the benefits of adhering to them. One important source of such rules of conduct can be found from transnational contracts. Market activity can also create a demand for certain type of state law that recognizes the rules of any given particular market. It can even reshape a whole financial regulatory framework in interaction with international organizations as discussed in Chapter 5. However, it is important to note that 'market participants' should be understood broadly as to include both private and public entities. States have many roles in finance in that

34 Robert D Cooter, 'Structural Adjudication and the New Law Merchant: A Model of Decentralized Law' (1994) 14 International Review of law and Economics 215, 226.

35 Bryan H Druzin, 'Planting Seeds of Order: How the State Can Create, Shape, and Use Customary Law' (2014) Brigham Young University Journal of Public Law 373 <https://works.bepress.com/bryan_druzin/13/> accessed 1 June 2019.

36 Francesco Parisi, 'Spontaneous emergence of law: customary law' in Boudewijn Bouckaert, Gerrit de Geest (eds), *Encyclopedia of Law & Economics Vol. 5* (Edward Elgar 2000) 603, 604.

37 Dalhuisen (n 23) 166.

38 Amitai Aviram, 'A Paradox of Spontaneous Formation: The Evolution of Private Legal Systems' (2004) 22 YLPR 1 <https://ssrn.com/abstract=421500> accessed 1 June 2019.

39 Parisi (n 36) 605–06.

they act both as regulators and market participants. The phenomena examined is not new. It remains true that '[a] very high degree of global contractual standardization and consensus as to appropriate market practice was achieved by the early 1980s'. States were actively involved in the transnationalisation of finance both in their capacity as market participants as well as its public facilitators.[40]

States finance their operations in the very same financial markets, use the same financial products transactions, and trade with the same private entities they seek to regulate[41] and may use the same transnational contracts as discussed in subchapter 5.2.6. In addition, states themselves are often the very owners of *transnational corporations* that transcend state boundaries in many ways and which are further discussed in subchapter 3.3.1.[42] It is important to note, also in legal theory, the multitude of roles that states have and its impact on the creation and evolution of transnational law.[43] As the evidence from the eurobond market in the 1960s and further along the line the OTC derivatives market that emerged in the 1980s demonstrates, nation states have often been the facilitators and catalysts of transnational law.

Law and finance interact, and transnational legal theory can help to identify how and why they interact. This may bring practice and theory closer to each other. Currently, legal practice and academic work are unfortunately seen as separate and remote from each other.[44] Both can be said to suffer from state-centric views lacking the intellectual framework for understanding transnational modern lex mercatoria and its operation.[45]

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40 Joanna Benjamin, David Rouch, 'The international financial markets as a source of global law: the privatisation of rule-making?' (2008) 2 Law & Fin. Mkt. Rev. 78, 78–80.

41 Stephen Kim Park, Tim R Samples, 'Towards Sovereign Equity' (2015–2016) 21 Stan. J.L. Bus. & Fin. 240, 277: W Mark C Weidemaier, Anna Gelpern, 'Injunctions in Sovereign Debt Litigation' (2014) 31 (1) Yale Journal on Regulation 189, 190, '[c]ourts can inconvenience sovereigns; they cannot make them pay'; for a contractual analysis of the wave of sovereign defaults in the early 1980s, Anthony Mauger, 'Sovereign debt restructuring: the practical background' (1986) 1 J.I.B.L. 100.

42 Alvaro Cuervo-Cazurra, Andrew Inkpen, Aldo Musacchio, 'Governments as owners: State-owned multinational companies' (2014) 45 Journal of International Business Studies, 919. In 2011, 19 of the largest transnational corporations out of 100 were owned by states, UNCTAD 2011, 'World investment report 2011', 28, Geneva: United Nations Conference on Trade and Development <http://unctad.org/en/PublicationsLibrary/wir2011_en.pdf> accessed 1 June 2019.

43 For the privileges and immunities of states and the tensions they bring to the market, Stephen Kim Park, 'Guarding the Guardians: The Case for Regulating State-Owned Financial Entities in Global Finance' (2014) 16 U. PA. J. Bus. L. 739, 786–87.

44 Sarah Paterson, Rafal Zakrzewski (eds), *McKnight, Paterson and Zakrzewski on the Law of International Finance* (2nd edition, OUP 2017) xi.

45 Dalhuisen (n 23) 135.

2.5 PRIVATE INTERNATIONAL LAW AND TRANSNATIONAL LAW

The system of rules in private international law (or in common law countries, conflicts of law) revolves around questions such as which law is applied in a legal situation where there is a cross-border element. Following these rules, a local judiciary is faced with essentially three questions. First the court is to decide whether it has the competence to hear the case (the question of jurisdiction). Second, if the court has the competence, it has to decide what law is applicable to the case (the governing law question). Third, the question may be whether a foreign judgment can be enforced by a domestic court.[46] These are factors in any finance transaction involving a cross-border element. Finance is, from a legal standpoint, ultimately about the enforceability of contracts in a court. However, private international law offers little direction as to how the black-letter law itself came into existence. In finance, the origins are in private normativity.

Transnational law touches upon private international law and conflict of laws through *transnational contracts* that seek to provide a contractual answer to problems that are settled with private contractual mechanisms. It is well established, as noted by *Georges GR Delaume*, that through contractual drafting, the terms and conditions of the contract can delocalize a transaction to a degree that transnational contracts are capable of 'transcending not only the borders of several countries, but also the confines of their economies and their legal systems'.[47] The stipulation of applicable law and forum can 'considerably reduce the chance of controversies between the contracting parties or at the very least make the outcome of possible disputes reasonably predictable'. Trade usages and accumulated experience manifested in transnational contracts co-exist and supplement domestic laws but 'cannot be expected to eliminate altogether the application of those rules'.[48] Instead of arguing in a court or in arbitration, the parties can restructure a transaction, typically by rescheduling repayments and then refinancing the maturities of existing borrowings.[49] Generally, arguing is costly and if market participants can avoid it, they generally will. In doing so, as behavioural economics tells us, private parties are capable of creating spontaneously private governance mechanisms that can substitute as well as complement public governance mechanisms.[50]

46 Paul Sebastianutti, 'What is This Thing Called International Financial Law – Part 2' (2009) 3 Law & Fin. Mkt. Rev. 155, 156.

47 Georges GR Delaume, *Law and practice of transnational contracts* (Oceana Publications, Inc. 1988) 98.

48 ibid 98–101.

49 P Durand-Barthez, 'The "governing law" clause: legal and economic consequences of the choice of law in international contracts' (2012) 5 I.B.L.J. 505, 514.

50 Wolfgang Kerber, 'Institutional change in globalization: transnational commercial law from an evolutionary economics perspective' (2008) 9 German L.J. 411, 423–24.

2.6 TRANSNATIONAL LAW IS ABOUT ACKNOWLEDGING BOTTOM-UP LAW MAKING

Much of the 'hard law' in finance has transnational origins and is thus the outcome of bottom-up law-making processes from financial collateral to bilateral close-out netting. Finance and law interact, and we do not have the foresight on this evolution. For example, should one have started to write about financial regulation governing the OTC derivatives market in 2007, almost everything would have had to been rewritten in 2009 given changes in the regulatory frameworks. Research is often too late to address urgent public policy questions.[51] Transnational contracts with their highly technical terms and conditions are obviously the end-product of conscious design. The spontaneous and often unknown element is in the evolution of these contracts, or more specifically, the financial instruments they govern. No one could have known what the first eurobond issue in 1963 could have led to in terms of technological and legal innovations that came with it. Nor could anyone have known the impact of the first interest rate swap executed in 1984 on the eurobond market and local exchange controls seeking to control cross-border capital movements. No one could have predicted the private regulatory mechanisms that the first credit default swap, designed and executed in 1994, would eventually give rise to. Nor would anyone have predicted the evolution of private governance mechanisms and the decisive role they would play close to two decades later in perhaps the largest financial turmoil ever witnessed when the Hellenic Republic defaulted on its debt.

Transnational law as a theory is the 'fourth category of law' alongside national, private international, and public international law. Transnational law evolves and transcends states through private ordering, social convenience, and non-legal conventions.[52] Private norms and state-made law interact, as *Bo Yuan* notes when summarizing earlier findings made in law and economics:

> [t]he interaction between social and legal norms can diminish their differences and creates a common basis for them to complement each other in guiding individuals' behaviour and maintaining social order.[53]

51 Henry T Hu, 'Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism' (1993) 102 (6) Yale Law Journal, 1457, 1499:

> [T]he ephemeral nature of financial truths would not be problematic for regulators if, consistent with the openness norm, knowledge of new theoretical developments spread quickly to regulators. Unfortunately, this is unlikely to be the case with much of the relevant financial science. The refereed academic journal, the primary source for the spread of new theoretical knowledge in science, is not a timely regulatory tool.

52 Lars Klohn, 'Transnational financial markets regulation – a conference' (2010) 11 E.B.O.R.

53 Bo Yuan, 'A Law and Economics Approach to Norms in Transnational Commercial Transactions: Incorporation and Internalisation' (2016) 9 Erasmus L. Rev. 5, 8.

Further, private norms can evolve into legal norms through 'incorporation process [which] reflects a bottom-up approach to law-making, through which selected social norms become more coercive and systematic'.[54] To further elaborate what bottom-up law-making means, *Christián Gimenez Corte* uses independent contract guarantees as an example of this phenomena.[55] *Janet Koven Levit* notes that there can be a great many legitimacy and accountability problems in law made bottom-up. She concludes:

> [t]o embrace bottom-up lawmaking, or cosmopolitanism, is not to condemn well worn international law paradigms-those rooted in the state-as legal relics left to fossilize. *It is merely to recognize that they alone do not tell the whole story and to offer a more complex, more nuanced, and multidimensional view of law*.[56]

This is exactly the argument put forward also in this research. Analyzing transnational contracts from the point of state laws and regulations will tell little about how the over-the-counter derivatives market actually operates. Transnational method offers a more complex, nuanced, and multidimensional answer to the question what transnational law is. According to Husa, such conceptions on transnational law are not even 'fundamentally radical because they do not gravely challenge the centrality of the state' even while accommodating the idea that transnational legal phenomen are real.[57] Perhaps the radical claim is that transnational law, as a way of looking at law, does not challenge the centrality of the state *at all* per se.

Transnational law emphasizes the importance of understanding the underlying transnationalisation processes which emerge from bottom-up *law* making. Transnational law holds an eclectic meaning, in that it can incorporate mixtures from different research areas. The benefit of eclecticism, as noted by *Henry TC Hu*, is that it can bring researchers closer to important findings made in other

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54 ibid 9.

55 Gimenez Corte (n 27) 367:

> [w]ith the incorporation of independent contract guarantees into the interplay between the substantive lex mercatoria and international commercial arbitration, this transnational law has detached itself from national and international laws, and has thus become a truly autonomous transnational law system, independent of both national and international law;

DV Snyder, 'Private Lawmaking' (2003) 64 Ohio State Law Journal 371, arguing that a significant amount of law is privately made and how also such laws can be made subject to the same kinds of standards as state-made law; Janet Koven Levit, 'Bottom-up lawmaking through a pluralist lens: The ICC banking commission and the transnational regulation of letters of credit' (2007–2008) 57 Emory L.J. 1147; Janet Koven Levit, 'A Bottom-Up Approach to International Lawmaking: The Tale of Three Trade Finance Instruments' (2005) 30 Yale J. Int'l L. 125.

56 Janet Koven Levit, 'A cosmopolitan view of bottom-up transnational law making: the case of export credit insurance' (2005) 51 Wayne L. Rev. 1193 (emphasis added).

57 Husa (n 2) 35.

disciplines.[58] For this reason, this research relies on findings made in legal theory, legal history, and law and economics in describing what bottom-up law-making is. *Stepan Wood* and others have emphasized the demand for various theoretical approaches that could shed light on and capture the dynamics of, among others, market participants and states.[59] In contract law:

> [T]he constant and widespread repetition of this method of negotiating and drafting contracts, and the reiteration of this practice of incorporating similar clause types into similar contract types, began to generate usages of trade and commercial customary usages.[60]

This type of contractual standardization may occur in the absence of any central legislative authority 'in a decentralized, spontaneous fashion with specific reference to law of a commercial nature' following the concept of *network effect* used in economics. Put simply, it refers to the effect of that the more users a good or service, or a language, has, the more valuable it becomes.[61] Much of what is said about transnational contracts can be attributed to this phenomen as further discussed in Chapters 3, 4, and 5.

The study of private normativity and its interaction with states has been the object of scholarly interest also under the concept of *transnational business governance*. As *Burkard Eberlein* and others have described, the emergence of private normativity is a creation of supply and demand. First, typically driven by business itself to reduce transaction costs and second, through evolution, to reduce negative externalities the business may create. This evolution can lead to the development of industry best practices, codes of conduct, and other transnational arrangements that do not originate from states. The self-governance of business is typically the outcome of non-national processes involving heterogenous actors from individual technical experts to large business entities which may or may not interact with government agencies.[62] Transnational contracts do not originate from states. As noted by *Peer Zumbansen*, lawyers are required to understand and appreciate the relevance of highly specialized

58 Henry TC Hu, 'Systemic Risk and Financial Innovation – Toward a "Unified" Approach' in Joseph G Haubrich, Andrew W Lo (eds), *Quantifying systemic risk* (University of Chicago Press 2013) 15.

59 Stepan Wood, Kenneth W Abbott, Julia Black, Burkard Eberlein, Errol Meidinger, 'The interactive dynamics of transnational business governance: A challenge for transnational legal theory' (2015) 6 TLT 333.

60 Gimenez Corte (n 27) 353, n 23.

61 Bryan H Druzin, 'Towards a Theory of Spontaneous Legal Standardisation' (2016) J.I.D.S. 1, 2.

62 Burkard Eberlein, Kenneth W Abbott, Julia Black, Errol Meidinger, Stepan Wood, 'Transnational business governance interactions: Conceptualization and framework for analysis' (2014) 8 Regulation & Governance.

and technical areas and their norms central to different governance regimes, both public and private.[63]

Some legal theories may have difficulties identifying private normativity and the role and power that transnational contracts possess. *Sandeep Gopalan* argues:

> Functionalism, liberal theories, and realism have serious limitations in explaining the design of international commercial agreements. These *theories assume that states are the primary actors, that law is binding and non-excludable, and that soft law is inferior to hard law. None of these assumptions apply to transnational commercial law*.[64]

The same could be said about the transnational law of the OTC derivatives market. Private market participants were and are the primary actors in the OTC derivatives market, state law is binding but in can be asked which state law applies to transnational arrangements, and transnational law is not inferior but different in its ontology in comparison to state law. 'Soft-law' is a problematic concept that cannot be discussed further in this research.[65] However, it is noted that discussion and disputes around the definition of 'soft-law' seem to suffer from the same kind of definitional disputes that hinder the discussion on factual and observable legal phenomena that demonstrably transcend the borders of states. It could be that especially Chapter 6 on transgovernmental organizations could contribute to this discussion.

Fabien Gelinas notes how both private and public entities operate in a transnational normative universe that is not based on public international law nor private international law:

> They are actors in a normative universe that is real but that transcends some of the traditional legal categories. This universe generates customs, and those customs give meaning to and govern agreements that would otherwise seem adrift on uncharted seas.[66]

What is known is that bilateral close-out netting existed in contract and generated a transnational custom in the OTC-derivatives market and gave particular meaning to the relevance of the ISDA Master Agreement architecture. Contract standardization,

63 Peer Zumbansen, 'The Ins and Outs of Transnational Private Regulatory Governance: Legitimacy, Accountability, Effectiveness and a New Concept of "Context" 13 (12) German L.J. 1269, 1278–79.

64 Sandeep Gopalan, 'A demandeur-centric approach to regime design in transnational commercial law' (2007–2008) 39 Geo. J. Int'l L. 327, 379 (emphasis added).

65 Harri Kalimo, Tim Staal, '"Softness" in international instruments: the case of transnational corporations' (2014–2015) 42 Syracuse J. Int'l L. & Com. 363, 384–391.

66 Fabien Gélinas, 'Arbitration as transnational governance by contract' (2016) TLT 1, 9.

the spontaneous development of shared language of lawyers, and the role that private market participants play in the creation of transnational contracts was witnessed already in the eurobond market in the late 1960s.[67] It could be argued that the purpose of transnational contracts is also to ensure adherence to any actual and even possibly applicable laws and regulations of states to any given financial transaction. Further, transnational contracts capture the ontology of transnational finance, transform it into legal language, and conceptualize the phenomena. They form the observable element of the modern lex mercatoria of finance. In the words of Corte, '[t]o understand the nature of the lex mercatoria it is necessary to understand how these [international] contract practices have contributed to its development'.[68] This is what Chapters 4 and 5 are focused on.

The argument put forward by *Nicola Dalla Guarda* is that states may not change their traditional legal paradigms and political tools to address transnational problems. To the contrary, states stay allegiant to their old ways even if this allegiance is the reason why public policy responses might not work or be ineffective against 'denationalized threats operating in a borderless environment'.[69] It would seem that Guarda is speaking of 'historical path dependence' or some very similar phenomena discussed further in subchapter 2.9.2.

2.7 CONTRACT AS A PRIVATE REGULATORY MECHANISM

The existence of transnational contracts is an empirically verifiable fact as is the normative force they hold. Private regulatory mechanisms exist in many different business sectors. They are a form of *self-regulatory rules* that can operate independently from states,[70] can be adopted, implemented, and enforced outside any formal context of delegation,[71] and, if and more likely, when the private mechanisms are made subject to public regulation, such governance structures are likely created between private actors and international and intergovernmental organizations without even the need for states' legislative intermediation.[72] In this

67 Norbert Horn, 'A Uniform Approach to Eurobond Agreements' (1977) 9 Law & Pol'y Int'l Bus. 753, 759, 762–63, 773; the language barrier between lawyers and professionals from other disciplines can be still considerable, Alastair Hudson, *The Law on Financial Derivatives* (5th edition, Sweet & Maxwell 2012), paras 2–30–31.

68 Gimenez Corte (n 27) 354–55.

69 Nicola Dalla Guarda, 'Governing the Ungovernable: International Relations, Transnational Cybercrime Law, and the Post-Westphalian Regulatory State' (2015) 6 TLT 211, 241.

70 Tony Porter, Karsten Ronit, 'Implementation in International Business Self-regulation: The Importance of Sequences and their Linkages' (2015) 42 Journal of Law and Society 413.

71 Deirde Curtin, Linda Senden, 'Public Accountability of Transnational Private Regulation: Chimera or Reality' (2011) 38 Journal of Law and Society 163, 164, also claiming that attempts to make these private mechanisms somehow more democratic is naïve.

72 Cafaggi (n 32, 2011) 21.

research, transnational contracts are also referred to as a form of private regulatory mechanism, alongside the private trade organizations that create them, since they fulfil these characteristics.

'Private regulatory mechanism' is a useful term for the purposes of this research. Perhaps it is useful to summarize some of the central findings of the latter Chapters of this research already at this point. Bilateral close-out netting was originally a self-regulatory rule that could be read in black-and-white from transnational contracts. It was adopted by market participants voluntarily into their respective contracts without any formal context of delegation from states. From early on, OTC derivative transactions were subject to governance structures created in interaction between private market participants and a international organization, the Basel Committee, first without at least direct state intermediation. The enforceability of bilateral close-out netting evolved from being a market practice into a public policy issue. States facilitated the use of bilateral close-out netting by enhancing legal certainty over its enforceability in national legal orders. What began as bottom-up law making by private market participants, ended up in top-down regulation bt international organisations, then legislation by states and, post-global financial crisis (GFC), regulations of transgovernmental organizations.

According to *Gralf-Peter Calliess* and others, several case studies suggest that the trend towards private regulatory mechanisms is accelerating globally. Private governance may produce the normative good of legal certainty on its own both for international and domestic transactions. Private regimes do not take over the responsibilities of states but simply take the operational and regulatory role for the purposes of producing legal certainty in areas where legislation and public regulation is more or less absent. Transnational private regimes and their fostering by states are an essential part of the evolution of governance that can be fostered through non-intervention or affirmative regulation.[73] Transnational private actors such as ISDA play an important part not only in the creation of private regulation but often is an elemental part of the processes leading to public regulation.[74] One illustrating example of the power of private trade organizations is that they draft model laws for states to implement if they wish to do so.[75] Private regulatory mechanisms, both

73 Gralf-Peter Calliess, Thomas Dietz, W Konradi, H Niewswandt, F Sosa, 'Transformations of Commercial Law: New Forms of Legal Certainty for Globalized Exchange Processes?' in Achim Hurrelmann, Stephan Leibfried, Kerstin Martens, Peter Mayer (eds), *Transforming the golden age nation state* (Palgrave Macmillan 2007) 83, 100–02.

74 Gabriel V Rauterberg, Andrew Verstein, 'Assessing Transnational Private Regulation of the OTC Derivatives Market: ISDA, the BBA, and the Future of Financial Reform' (2013–2014) 54 Va. J. Int'l L. 9; Stephen M Maurer, 'Public Problems, Private Answers: Reforming Industry Self-Governance Law for the 21st Century' (2013–2014) 12 DePaul Bus. & Comm. L.J. 297.

75 John Biggins, Colin Scott 'Licensing the Gatekeeper? Public Pathways, Social Significance and the ISDA Credit Derivatives Determinations Committees' (2015) 6 TLT, 370, referring to the 'Model Netting Act' published by ISDA, 379–80, n 59. Currently, this privately created Act is in its 2018 version <https://www.isda.org/2018/10/16/isda-publishes-updated-model-netting-act/> accessed 1 June 2019.

the ISDA Master Agreement architecture as well as a private committee, played an elemental role in the sovereign default with the largest repercussions perhaps ever witnessed as discussed in subchapter 5.10.3.

According to *Kathryn Collard*, it would be even advisable for public financial regulators to co-regulate the OTC derivatives market together with a private trade organization, ISDA, a trade organization which has regulated the OTC derivatives market privately through contract since the 1980s.[76] Private regulatory mechanisms can bind private and public organizations alike.[77] Taking into consideration that regulating the OTC derivatives market from top-down, without decisive input from the private sector, indeed brings many problems. It cannot be ruled out that Collard's suggestion might one day become reality out of practical necessity. A simplified categorization might be useful to explain the interactions between private regulatory regimes and states. States can interact with private norms on three levels: 1) they can choose to recognize and ignore private norms; 2) incorporate private norms into state legislation; or 3) by recognizing a private body as the regulator.[78] ISDA, for example, has thus far operated mainly at the first two of these levels[79] although this could be an understatement considering the role it has in this market.

It is worthwhile to note that private regulatory mechanisms can complement or even displace arbitration, a traditional discussion area also for transnational law. For example, the Panel of Recognised International Market Experts in Finance (P.R.I.M.E.) offers a private mediation service. P.R.I.M.E. focuses on disputes concerning particularly complex financial transactions that typically involve derivatives and which require the interpretation of the ISDA MA architecture. The goal of the mediation proceedings is to reach a settlement agreement between disputing parties[80] possibly in an expedited and less-costly procedure than other types of dispute resolutions.[81] The current legal uncertainty surrounding the regulatory framework applicable to OTC derivatives market and the very possibility of a *regulatory collision* may well create a demand for such mediation services

76 Kathryn Collard, 'Advantages of a co-regulatory OTC derivatives regime' (2014–2015) 46 Geo. J. Int'l L. 877.

77 Barnabas Reynolds, Ellerina Teo, 'Early Bank Recovery and Resolution Directive (BRRD) Experiences: Lessons Learned from Greece' (2016) 31 J.I.B.L.R. 2016, 359, 361; Mark Jewett, 'Approaches to Sovereign Debt Resolution: Recent Developments' (2015) 30 B.F.L.R. 311; Rainer Kulms, 'Private creditors and sovereign default: from Argentina to Greece' (2012) Annals Fac. L. Belgrade Int'l Ed 65; RM Auerback, 'Sovereign debt – default and restructuring of debts owed to private creditors' (2003) 18 J.I.B.L.R. 2003 440.

78 Lawrence A Cunningham, 'Private Standards in Public Law: Copyright, Lawmaking and the Case of Accounting', (2005) 104 Mich. L. Rev. 291.

79 Rauterberg, Verstein (n 74) n 8, 24.

80 Camilla J Meijer, ML Perera-de Wit, 'P.R.I.M.E. Finance: A New Dispute Resolution Facility for Conflicts Relating to Complex Financial Products' (2013) 14 No. 2 Bus. L. Int'l 153; Piergiuseppe Pusceddu, 'Mediation of international financial disputes' (2015) 30 J.I.B.L.R. 661, 666–70.

81 Peter Cresswell, Stuart Dutson, Conor Redmond, 'Towards an expedited and cost-effective arbitration award in financial services disputes' (2016) 82 Arbitration 306.

such as those offered by P.R.I.M.E.[82] The evolution may even be leading towards private regulatory mechanisms that do not touch upon state institutions at all but which operate independently.

2.8 LEGAL RISK IN FINANCE

According to *Alaistair Hudson*, who describes the role of derivatives lawyer essentially as being that of managers of *legal risk* which also this research is much about, 'Our roles as lawyers is not to think ourselves above or beyond the law, but rather to understand how finance and law interact'.[83] States and public regulators are one risk factor in finance. Since legal risk affects the dynamics and interactions between different normativities, it is useful to explore the concept in some detail also in legal theory. The European Central Bank defines legal risk as follows:

> [t]he risk of a loss being incurred on account of the unexpected application of a law or regulation, or because a contract cannot be enforced. This often manifests itself in an unforeseen interpretation of either the system's contractual basis or the legislation on which the contracts between the parties are based – e.g. in connection with a court ruling.[84]

The concept of legal risk is relevant also for legal theory since it is this particular risk that drives transnationalisation processes in finance. Much of the history of both eurobonds as well as the OTC derivatives market was about attempts to reduce legal risk through contractual means. In time, through repeated interactions, these contracts became transnationalised as were these particular markets themselves. To draw a contemporary example, legal risk remains highly topical in the European Union where the exercise of bail-in powers of public regulators over distressed financial institutions may unduly interfere with the human right to private property of the creditors of such financial institutions. The exercise of these powers can be seen as a form of legal risk.[85] More generally, national laws can be used as disguised

82 Colleen M Baker, 'When regulators collide: financial market stability, systemic risk, clearinghouses, and CDS' (2015–2016) 10 Va. L. & Bus. Rev. 343, 384–85.

83 Hudson (n 67) paras 0–40–42.

84 European Central Bank, 'The Payment System: payments, securities and derivatives, and the role of the Eurosystem' (2010) 127, <https://www.ecb.europa.eu/pub/pdf/other/paymentsystem201009en.pdf> accessed 1 June 2019.

85 Marco Lamandini, David Ramos, Javier Solana, 'The European Central Bank (ECB) Powers as a Catalyst for Change in EU Law, Part 2: SSM, SRM, and Fundamental Rights' (2017) 23 Colum. J. Eur. L. 199; Tracy Chiyedza Maguze, 'EU bank recapitalisation and the bail-in option: an analysis of the effects of mandatory bail-in on creditors' property' (2016) 5 UCLJLJ 207, 218–21; Matthias Haentjens, 'Party

expropriation, nationalization or other types of interference on private property. Therefore, market participants also manage and reduce *political risk*, a wider concept that includes legal risk, on their investment programmes through bilateral investment treaties, as well as contractual arrangements and legal structures like transnational trustee companies.[86]

All market participants, from individual consumers to states, from startups to large transnational corporations, operate in an environment that is unpredictable. Risk is at the core of any profit seeking, for which reason the members of different communities adapt to their environment and create laws that shield them and the trade itself from at least those risks that are identifiable. Whereas states enact laws in black-letter, private market participants form trade organizations and private regulatory mechanisms.[87] States can be a risk not only to market participants but on a systemic scale to the whole financial system.[88] It might be this way because of the modern credit culture that promotes easy access to credit for all regardless of their creditworthiness, both in good and bad economic times. It is the public policy of our time regardless of who is in political charge, and 'Banks are never stronger than their clients'.[89]

2.9 PRIVATE NORMATIVITY AND TRANSNATIONAL LAW

2.9.1 EVOLUTIONARY ASPECTS OF PRIVATE NORMATIVITY

Michael Torrance has noted how transnational norms are private in origin, and how the frameworks they compose share many of the same systemic and structural characteristics of state-based positive law.[90] *Jan M Smits* sees an evolutionary aspect in transnational law. He asks that if positivist theory cannot explain the developments in private law, could the application of evolutionary theory help us to understand these developments. He describes:

Autonomy, Public Policy and European Bank Insolvency Law' (May 21, 2015) Leiden Law School Research Paper; Hazelhoff Research Paper Series No. 7, <https://ssrn.com/abstract=2608903> accessed 1 June 2019.

86 Richard Hay, 'Protecting assets from political risk' (1997) 3 P.C.B. 152.

87 Rauterberg, Verstein (n 74) discussing also the limitations of private regulation in the OTC derivatives market, 40–42.

88 Kulms (n 77) 65.

89 Jan Dalhuisen, *Dalhuisen on Transnational Comparative, Commercial, Financial and Trade Law Volume 3 Financial Products, Financial Services and Financial Regulation* (6th edition, Hart Publishing 2016) 551–54.

90 Michael Torrance, 'Persuasive authority beyond the state: a theoretical analysis of transnational corporate social responsibility norms as legal reasons within positive legal systems' (2011) 12 German L.J. 1573, 1574.

> [w]hat the evolutionary perspective has to offer is an external account of how law develops. It does not inform us about the contents of law, but only explains why the law develops as it does.[91]

This research is an external account of how the law around eurobonds and OTC derivatives evolved and why. As a side product, the research also informs about the contents and evolution of law of the past. Similarly, *Wolfgang Kerber* notes how the evolution has led to 'new governance solutions' in the form of increasing choice of law, private governance instead of private law, and relying on private arbitration instead of public courts.[92] There might not be market demand for common European private law imposed in black-letter and from top-down by states.[93] When asked, over 90 per cent of market participants responded that they have never used the Principles of European Contract Law or incorporated these principles into their contracts as the governing law.[94] One reason for this may be that the calls for harmonization of private law are driven by ideological objectives.[95]

Smits divides his insights drawn from evolutionary theories into three parallel arguments. First, he notes that organisms are to a large extent path dependent. In a legal context, codified rules may become somewhat unable to adapt to change. As an example, he describes how the courts of continental European countries may have become unable to invoke certain legal rules once law became equated with codified law. Pre-existing rules or doctrines not codified were no longer viewed as *legal* rules because they were not codified into black-letter law.[96] This observation begs the question of can, and if yes, how, transnational norms be transformed into codified laws and financial regulation. The short answer is yes, transnational norms can become codified as described in Chapter 5. Bilateral close-out netting created in the market through repeated interactions between merchants can demonstrably be transformed into and reflected in state law and financial regulation. This takes

91 Jan M Smits, 'Darwin at work: how to explain legal change in transnational and European private law' in Peer Zumbansen, Gralf-Peter Calliess (eds), *Law, Economics and Evolutionary Theory* (Edward Elgar Publishing 2011) 322, 324–25.

92 Kerber (n 50) 412.

93 Jan M Smits, 'European Private Law: A Plea for a Spontaneous Legal Order' in Deirdre M Curtin, Jan M Smits, A Klip, JA McCahery (eds), *European integration and law; Four Contributions on the Interplay between European Integration and European and National Law* (Intersentia 2006) 74–78.

94 The Oxford Institute of European and Comparative Law and the Oxford Centre for Socio-Legal Studies, 'Civil Justice Systems in Europe: Implications for Choice of Forum and Choice of Contract Law – A Business Survey' (2008), Question 26 < https://www.fondation-droitcontinental.org/fr/wp-content/uploads/2013/12/oxford_civil_justice_survey_-_summary_of_results_final.pdf> accessed 1 June 2019.

95 Bénédicte Fauvarque-Cosson, 'The Need for Codified Guiding Principles and Model Rules in European Contract Law' in Roger Brownsword (ed), *The Foundations of European Private Law* (Hart Publishing 2011) 79.

96 Jan M Smits, 'Applied evolutionary theory: explaining legal change in transnational and European private law' (2008) 9 German L.J. 477, 482–84, referring to a Roman law doctrine of *laesio enormis* (extraordinary injury) that became extinct following the codification of private law.

place in interaction between a private trade organization and public international organizations. It might even be said that when bilateral close-out netting became part of public financial regulation and codified law, it became so institutionalized that it is now part of the 'DNA' of modern finance and thus resistant to change.

The second observation of Smits notes how the adaptation of a species can bend towards simplicity rather than complexity. In the law market, market participants favour certain governing laws and jurisdictions over others.[97] It is true that some jurisdictions are favoured over others and one reason out of many might be that in relative terms the former jurisdictions offer simplicity in comparison to the latter. Finally, Smits makes the argument that the evolutionary insight can provide not only a theoretical explanation but also a justification for legal diversity and, following from justification, the acknowledgment that different rules may be justifiable for similar problems.[98] In the OTC derivatives markets, bilateral close-out netting is indeed a transnational rule which gained legal exemption from the ordinary rule of insolvency laws according to which unsecured creditors of a bankruptcy estate are to be treated in the same manner. It is an exemption rule, or a 'safe-harbor', for certain types of financial transactions according to which, in simplified terms, a contractual clause that allows a counterparty to terminate the transactions upon counterparty insolvency is enforceable. It is generally deemed as justified public policy choice, but it has its critics as summarized in subchapter 5.7. Market participants favour some jurisdictions over the other perhaps one of the reasons being that the legal orders of the former and their courts are more receptive to transnational law as discussed in Chapter 4.

2.9.2 THE PATH DEPENDENCE OF SYSTEMIC THINKING

It is clear that legal scholarship on transnational law is much about private normativity, repeated interactions, and spontaneously formed orders as discussed above and further especially in Chapter 3. Why claim something to the contrary? Transnational law can also be about 'rethinking legal thinking' and it is clear that this leads to slight inconsistencies at best, and to clear contradictions at worst, between academics who have rethought ideas from their own perspectives. These perspectives, in turn, reflect various legal traditions and theoretical models.[99] Such reconceptualizations seem to be a newer phenomenon in legal scholarship. In the transnationalisation of finance, many of the events that took place in the 1960s

97 ibid 486–88.

98 ibid 489–90.

99 Miguel Maduro, Kaarlo Tuori, Suvi Sankari (eds), *Transnational Law – Rethinking European Law and Legal Thinking* (CUP 2014) 2.

were an anomaly to the legal scholars of that time. Private normativity and repeated transactions in business took place that transcended the boundaries of states and, in the process, essentially, as the evidence gathered for Chapter 3 suggests, no laws were generally breached. No solution was found from written 'black-letter' legislation and regulations to even conceptualize the phenomena with the vocabulary that existed at that time. Hence, these anomalies were referred to being 'transnational' in their ontology. In contrast, from a state-centred perspective, private law is 'private', meaning that it is a mere subcategory of public law that is 'no less the arena of political power than the public law created in legislation and administration'.[100] However, construing and viewing financial markets as some type of political abstraction that could be made to simply obey the commands of states through force and policital power is problematic for various reasons discussed throughout this research. From a methodological point of view, transnational law without private normativity is not transnational law but the type of positivist law that wholly excludes nonstatist sources of law. Fortunately, the private normativity aspect is acknowledged at least in some contemporary studies on transnational law as discussed in subchapter 2.10.2 below.

As noted by *Lars Viellechner*, there is a strong belief in the unity of the written hard law, first grounded on religion, then on the state.[101] State itself is a legal tradition, which is argued to be capable of becoming 'more and more receptive to non-state order and non-state sources of law'.[102] Reconceptualizing transnational law as to not to include private normativity runs too many risks. Transnationalisation is real but it can go unnoticed if the inherent private normativity aspects of transnational law are ignored. To summarise the problem:

> Analytical legal theory that takes the experience of the law-state as the standard and measure of legality explains the existence and nature of non-state types of prima facie legality in the following way: intra-, trans-, supra-, and super-state social phenomena are legal phenomena only to the extent that (i) they share the characteristic features of state law or (ii) are in some way actually supported by or connected to state practice or recognition [...] Little conceptual or normative room is left for novel, state-independent forms of legality to emerge.[103]

100 Curtin, Senden (n 70) 164; Hans Kelsen, *Introduction to the Problems of Legal Theory – A Translation of the First Edition of the Reine Rechtslehre or Pure Theory of Law* (OUP 1996) 95–96.

101 Lars Viellechner, 'Responsive Legal Pluralism: The emergence of transnational conflicts law' (2015) 6 TLT 312, 319.

102 Glenn (n 31) 704, 713.

103 Keith Culver, Michael Giudice, *Legality's Borders. An Essay in General Jurisprudence* (OUP 2014) XXI; Oren Perez claims that 'Traditional legal theory has failed to produce a theory that adequately captures the structure and dynamics of quasi-legal systems', Oren Perez, 'Fuzzy Law: A Theory of Quasi-Legal Systems' (2015) 28 Can. J.L. & Juris. 343.

If something cannot be even conceptualized, neither can the problems associated with that something. The other problem is that historically, as demonstrated in Chapter 3, transnational law was, and indeed still is, about novel, state-independent or perhaps more descriptively, autonomous, since market activity takes place in a society, forms of legality. The initial choice in systemic thinking concerning law is the exclusivity aspect of state-made law, meaning that state-made legislation is law, whereas other types of norms and the normative orders they form are not. To repeat, a functional rather than formal understanding of what is 'law' is necessary for understanding private normativity. *Philipp R Wood* has noted metaphorically how '[t]he law is the one universal secular religion which practically everybody believes in' while at the same time acknowledging how flawed the law may more than occasionally be. Laws may be intrusive and excessive, they may not enjoy observance, they may be misused as well as abused, and they can be used to serve the state rather than the persons it governs.[104] The same might be said about transnational law, but as said, such problems cannot even be identified without proper conceptualizations.

Mikhail Xifaras notes that the discourse on 'global law' is open to non-state law. Xifaras describes:

> Some rightly talked about Non-State Law. It is rare, however, that we manage to identify legal phenomena that are clearly independent of national legal orders. Most common examples are forms and practices that do not have their origin in the State, in which the role of the State is transformed, but the State does not disappear.[105]

Indeed, the state does not disappear since they remain as the gatekeepers of contract enforceability which, in turn, depends on public policy. Neither can nation states be declared bankrupt and out of existence through this process unlike corporations as further discussed in subchapter 2.10.2. Put perhaps too abstractly, transnational law cannot declare independence from the societies in which it operates in.

One might consider that only such laws with sufficient *input legitimacy*, which refers to a structure for democratic participation in rule-making of a given community, qualifies as law. A collective of people should be able to cast their vote through this structure in order for private normativity to be considered 'hard' law that is made official through a democratically elected body, a parliament. Or absent input legitimacy, transnational law should have *output legitimacy*, i.e. 'government by the people', where the legitimacy follows from the participation of a collective of people with a collective identity to a rule-making structure that

104 Philip R Wood, *The Fall of the Priests and the Rise of the Lawyers* (Hart Publishing 2016) 3, 241–42.

105 Mikhail Xifaras, 'The Global Turn in Legal Theory' (2016) 29 Can. J.L. & Juris. 215, 220.

the collective can influence.[106] If this is the case and norms and rules require either input or output legitimacy, the problem of illegitimacy goes much further than the legitimacy of transnational law. Much of 'hard' law has never been subject to either direct democratic processes or to indirect rule making-structures. As noted by *Jan Dalhuisen*, much of what is referred to as commercial law or financial law, legal principles, and even the financial instruments predate the birth of modern nation states and law codifications. They have never been made subject to, or come into existence through, any democratic processes to begin with. In addition, many of the academic models used, especially in civil law countries, as the founding parts of designed state legal systems are themselves something that have never been subject to any democratic participatory processes. The 19th and 20th centuries are the centuries that saw the rise and spread of monopolistic legal codifications giving law its territorial character, theorized legal research as a distinct field of academic study focusing mostly on state legislation denying the autonomy of any other source of law. [107] By default, transnational contracts discussed in this research are, and as the evidence tells they are, designed to be legal, enforceable and compliant with all laws and regulations.

At worst, private normativity which is the key in understanding transnational law goes unintentionally or, through wilful ignorance, bypassed altogether. *Systemic thinking*, as coined by Dalhuisen,[108] focuses on legal rationality, systematization, coherence, and black-letter codifications and legislation that have the impossible task of telling the answer to any past, current, and future legal problem. Indeed, the idea that law and regulation is merely something that states can produce and ought to be capable of being read from codified black letter rules, laws, or regulations, remains paradigmatic. This is in many ways problematic which is here illustrated through an analogy. In the 20th century, printed phonebooks, updated yearly, told the numbers to landline telephones. Around the millenium, cellular phones, pre-paids, voice-over-internet protocols, and other modern communication technologies emerged. These were the outcome of repeated interactions between private individuals. New concepts had to be invented for new phenomen that were close to being science fiction only a few years before their invention. For a systemic thinker, the technological development is not the outcome of technological innovations created by individuals seeking to create products and services for which there is a market demand. Quite

106 MAP Bovens, 'The Quest for Legitimacy and Accountability in EU Governance' in Paul't Hart, Deirdre Curtin, Mark Bovens (eds), *The Real World of EU Accountability: What Deficit?* (OUP 2010) 20–23.

107 Jan Dalhuisen, *Dalhuisen on Transnational Comparative, Commercial, Financial and Trade Law, The Transnationalisation of Commercial and Financial Law and of Commercial, Financial and Investment Dispute Resolution. The New Lex Mercatoria and its Sources. Volume 1* (6th edition, Hart Publishing 2016) 7, noting that academic models are exercises on monopolistic and systemic consistency and conceptual unity never mind the commercial or financial realities of finance, 7–10.

108 ibid 6–10.

the contrary, these products are the outcome of suspicious, assumedly immoral, maybe even criminal, acts made in the shadowy waters of even more shady private, *foreign*, information and communications technology sector which clearly is there for the sole purpose of challenging the rational, systemized, coherent, written, black-letter, state-regulated phonebook! In the face of evidence, this makes little sense and the problem might not lie in the technological development but in the underlying theoretical premise studying this development. Systemic thinking might be trapped in *evolutionary path dependence*, which, to draw an analogy from biology, means that the evolution is directly constrained by history which determines the possibilities of today and tomorrow.[109] *Gerard Alexander* has defined path dependence as follows:

> A range of technological, economic, social, and political arrangements, once in place, appear to generate patterns of costs and benefits such that rational actors prefer to maintain the status quo even if an alternative might provide higher aggregate returns in the long run. Actors support the status quo not because change stands to generate some costs – which is true of almost all changes – but because change imposes significant net costs at least in the short term. The longer actors operate within such a status quo, the more any shift to an alternative is unattractive. Initial choices are thus 'locked in'.[110]

There is plenty of scientific evidence beginning at least since the 1960s confirming that private normativity is real, and these normativities transcend state borders and categories of law. Being hostile towards the idea that transnational law is about acknowledging private normativity becomes a question of preserving power and control as well as retaining status quo. Legal research needs higher aggregate returns than systemic thinking is able to produce.

109 Oona A Hathaway, 'Path Dependence in the Law: The Course and Pattern of Legal Change in a Common Law Systems' (2001) 86 Iowa Law Review 601, 613–17.

110 Gerard Alexander, 'Institutions, Path Dependence, and Democratic Consolidation' (2001) 13 (3) Journal of Theoretical Politics, 249, 254; Kerber (n 50) 419–20:

> [t]he future development of the law is dependent on the previous states of the law. This is a descriptive term and path dependence can lead to many outcomes, favourable and unfavourable.

2.10 THEORETICAL FRAMEWORK

2.10.1 WHY A THEORETICAL CONSTRUCT IS NEEDED?

Empirical research on transnational law suffers 'from a sufficient intellectual framework, which should ideally precede any such research and direct it'.[111] This is why the theoretical framework and construction of a transnational legal order is needed. Transnational legal order is a theoretical construct that tells us that transnational law operates autonomously, markets consist of autonomous individuals, but not independently from states and their legislation and regulations. Even the existence of such a theoretical construct is contrary to the codification ethos of the nineteenth century prevalent especially in the Continental European thinking in which autonomous source of law, such as custom, do not exist without state recognition.[112] Transnational method aids the understanding of non-statist sources of law. *Maciej Borowicz* notes that in this context, there exists a conceptual gap for exercizing private power in a transnational context. This gap is so wide that it limits even the identification of what is the question from a normative standpoint.[113]

While finance might be hard to conceptualize in legal theory, finance is driven by pragmatic every-day negotiation and execution of contracts that seek to give a return on investment, to hedge risks, to speculate, to engage in arbitrage, or whatever the reason for any particular transaction may be. The substantive part of this research could have been written without a single reference to any legal theory or to transnational law as a concept but then, it would have lacked a theoretical structure. Much of the contemporary literature concerning private law or financial regulation seldom refers to any particular legal theory. [114] In financial regulation, the theoretical discussion concerns theories like liberal intergovernmentalism, public choice theory, and historical institutionalism,[115] but apparently not transnational law.

The observable elements of transnational law, such as transnational contracts, remain in existence and unaffected regardless of the legal theoretical perspective or the lack thereof of the observer. To draw an analogy, the falling tree in the

111 Dalhuisen (n 23) 135.

112 Dalhuisen (n 107) 82–83.

113 Maciej Borowicz, 'Private Power and International Law: The International Swaps and Derivatives Association' (2015) 8 Eur. J. Legal Stud. 46, discussing close-out netting and private regulatory mechanisms in the OTC derivatives industry as a form of transnational power.

114 For example, none of the writers in Sarah Paterson, Rafal Zakrzewski (eds), *McKnight, Paterson and Zakrzewski on the Law of International Finance* (2nd edition, OUP 2017) discuss legal theory.

115 Eilís Ferran, Niamh Moloney, Jennifer G Hill, John C Coffee, Jr, *The Regulatory Aftermath of the Global Financial Crisis* (CUP 2013) 17–23.

forest transmits physical particles propagated through a medium, even if there is no one to hear it, or regardless of what is the listener's subjective interpretation of the origins and ontology of what is referred to as 'sound'. As noted by *Katharina Pistor*, it is for the scientific observer to acknowledge these observable elements, set them into the legal theoretical model of their choosing best fitted to observe certain phenomena, or even construct a new one, and draw her conclusions.[116] As *Stepan Wood* has noted, legal scholars do recognize such private interactions, but their accounts are flawed followed by the divergent theoretical, methodological, and normative perspectives.[117] Common perspectives are needed, and acknowledging the inherent private normativity aspect of transnational law is one place to overcome these challenges.

2.10.2 TRANSNATIONAL LEGAL ORDER

'Transnational legal order' and 'transnational legal ordering' (TLO) involves both public and private actors which can differ in their geographic, substantive, and organizational scope as discussed below. This definition is compatible with the idea of private normativity as a non-statist source of law and should capture the most crucial element of transnational law, private normativity, and transnationalisation processes. Already at this point it should be understood that in this research, legal order can also include those that do not arise from states but 'from participatory structures or communities that spontaneously produce their own laws'.[118]

Under TLO, one way of defining 'transnational law' is to see it as a 'a collection of formalized legal norms and associated organizations and actors that authoritatively order the understanding and practice of law across national jurisdictions'. Associated organizations and actors are to be construed and understood broadly.[119] 'Law' is to be understood as establishing generalized normative expectations understood and used by actors within a particular context for purposes of constraining and facilitating particular behaviours.[120] This definition, while welcomed, still focuses on formalized legal norms and practice of law across national jurisdictions. In the transnational market, there is more to it. Bilateral close-out netting became a generalized normative expectation in the OTC derivatives market. It also became used by market participants for the purpose of facilitating the procedure to be

116 Katharina Pistor, 'A Legal Theory of Finance' (2013) Journal of Comparative Economics 315, 317.

117 Wood and others (n 59) emphasizing, in contrast to this research, a prescriptive and normative undertone for transnational law, 339.

118 Dalhuisen (n 23) 132.

119 Halliday, Shaffer (n 18) 6.

120 ibid 11.

followed upon counterparty default. It became formalized first in a transnational contract, the ISDA Master Agreement, and after that, in financial regulation as well as in EU Directives and, through transposition, in national legal orders. The facilitator behind this was an associated trade organization, ISDA. As discussed in Chapter 5, the use of close-out netting provisions was generally not illegal. Their enforceability was uncertain in different jurisdictions when a counterparty to a transaction became insolvent. Regardless, the use of these provisions was already part of lex mercatoria of finance, as understood in this research, but there was no formalized legal norms in existence. The normative power that this type of private normativity yields should not go unacknowledged.

TLO qualifies as a transnational *legal* order when it fills three attributes. Transnational law of OTC derivatives market fills these three attributes. First, the norms must be produced by, or in conjunction with, a legal organization or a network that transcends the nation-state. These legal organizations can include primary institutions of law, legislatures, executive departments, agencies, and courts, or 'quasi-legislature' engaged in secondary lawmaking. Importantly, this attribute also identifies norms created by non-state actors, which in turn generally seek recognition from states to legitimize the norms and enhance their own authority. Through this process, norms of non-state actors are part of the formation and institutionalization of legal norms.[121] In the OTC derivatives market, the norms are produced in interaction with, among others, national central banks, the Basel Committee, an international organization, and a private trade organization, ISDA, as demonstrated in Chapter 5. Second, the norms 'directly or indirectly, formally or informally, engage legal institutions within multiple nation-states, whether in the adoption, recognition, or enforcement of the norms'. This attribute incorporates private lawmaking to the definition of TLO: 'Private transnational institutions develop formalized norms that are to be used in contracts and, if necessary, ultimately recognized and enforced by national courts'.[122] Third, '[t]he norms are produced in recognizable legal forms', i.e. that the form must by formalized through the use of formal texts, whether these texts take the form of written rules, standards, model codes, or judicial judgments — without excluding formalization by private actors.[123] Both apply to the OTC derivatives market where ISDA formalized the norms which ultimately became recognized and enforced by national courts, also demonstrated in Chapter 5.

While otherwise compatible with the idea of transnational law being about private normativity, the definition of a TLO has one deficiency in regard to the latter. One might think that before the 1990s, there was no transnational legal

121 ibid 12.

122 ibid 12–14.

123 ibid 15.

order for corporate bankruptcy. It is true that that before international cooperation, the attitude inherent in national legal systems varied widely towards companies in financial distress.[124] It has been argued that the history of the 'transnational financial legal ordering' began as late as 1974 when the Bank for International Settlements introduced the Basel Concordat, a form of financial regulation still used today.[125] The argument here is that transnationalisation processes leading to a financial legal order precede the establishment of formal rules by states.

Following a cursory review, it is true that many policy instruments that contributed to a transnational financial order were introduced in the 1990s. The point is that transnational legal order can operate without such policy instruments. Non-binding and binding regulations, were introduced in the 1990s from UNCITRAL Model Law on Cross-Border Insolvency (1997)[126] to EU Regulation on Cross-Border Insolvency (1999),[127] to name a few.[128] It is worth highlighting the significance of bilateral close-out netting, in that its legal recognition was further promoted by UNCITRAL in the Practice Guide on Cross-Border Insolvency (UNCITRAL 2009) and a Guide to the Enactment and Interpretation of the Model Law (UNCITRAL 2014),[129] and by the World Bank in the Principles for Effective Insolvency and Creditor/Debtor Regimes.[130]

It is also true that the emergence of a TLO on the complex domain of cross-border insolvency would seem inconceivable without conscious design of TLO. First, there would be the absence of international bodies or networks that need to give the order its legal form, and second, following from this absence, there is presumably nothing that could order social relationships in a manner 'that transcend the nation-state in one way or another'.[131] In practice, however, it would seem that TLOs do exist and order can be created even in the absence of both of the aforementioned and assumed prerequisites for transnational legal ordering. One important bankruptcy case from the 1970s may illustrate this argument of how a TLO can manifest itself

124 Susan Block-Lieb, Terence C Halliday, 'Settling and Concordance – Two Cases in Global Commercial Law' in Halliday, Shaffer (n 18) 77–78.

125 Eric Helleiner, 'Regulating the Regulators – The Emergence and Limits of the Transnational Financial Legal Order' in Halliday, Shaffer (n 18) 231, 236.

126 UNCITRAL Model Law on Cross-Border Insolvency (1997) <http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model.html> accessed 1 June 2019.

127 Council regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings, OJ L 160, 30.6.2000, p. 1–18, repealed.

128 While they all recognize same public policy objectives, they differ in their scope. Rizwaan Jameel Mokaal, 'Liquidity, systemic risk, and the bankruptcy treatment of financial contracts' (2015–2016) 10 Brook. J. Corp. Fin. & Com. L. 15, 45-48.

129 Block-Lieb, Halliday in Halliday, Shaffer (n 18) n 188, 78.

130 The World Bank, 'The Principles for Effective Insolvency and Creditor/Debtor Regimes' (revised 2015) <http://pubdocs.worldbank.org/en/919511468425523509/ICR-Principles-Insolvency-Creditor-Debtor-Regimes-2016.pdf> accessed 1 June 2019.

131 Halliday, Shaffer (n 18) 20.

without a designed framework save for the existence of central bank involvement in the background and the enforcement of a settlement agreement by a state court. It is also a reference case on how a random historical event can act as a catalyst for international cooperation that in turn became central to the development of the OTC derivatives market in the 1980s and the whole banking industry. Before this case analysis, the hierarchy of transnational legal order needs to be drawn.

2.10.3 THE HIERARCHY OF TRANSNATIONAL LEGAL ORDER

Steven L Schwartz and *Lucy Chang* note that humans, that are in many ways limited, have to rely on simplifications of reality and routines, and these simplifications can develop into a custom within a community. Although generally beneficial for society, these customs can become harmful when they do not approximate reality and amplified by the fact that humans do not wish to reassess customs they are used to.[132] There is no reason to believe that legal theorists are immune to this which means that also the following hierarchical portrayal of laws is bound to be incomplete in many ways. However, legal theoretical framework may provide the observer with a starting point for making empirical observations. As put by *Katharina Pistor*:

> The theory of science teaches us that one can hardly identify relevant empirical observations without an underlying idea of an order in one's mind, i.e. without a theory. This does not mean, however, that one is limited to the mental maps that are currently in use.[133]

The mental map used in this research is currently in use and its central premises are as follows:

(i) Non-statist sources of law are real. Law is *not* something that is in the exclusive domain of states, which have the power to legislate but which is but one source of law;
(ii) Contracts create legal obligations between private natural and legal persons who are exercizing their innate and inalienable right to private property, exercise of and transferability of private property, and the principle of pacta sunt servanda;[134]

132 Steven L Schwartz, Lucy Chang, 'The Custom-to-Failure Cycle' (2012) 62 Duke Law Journal 767.

133 Pistor (n 116) 317.

134 Fabien Gélinas, 'Arbitration as transnational governance by contract' (2016) TLT, noting how pacta sunt servanda, 6:

> [c]uts across both space and time as a staple moral and legal principle is that consent somehow resonates universally as one of the most powerful sources of legitimacy available. The legitimating power of consent

(iii) Private norms can qualify as *legal* norms which are not necessarily and automatically subordinate to any particular state laws; and
(iv) which states may or may not recognise and enforce;
(v) Transnational law does not claim supremacy over national legal systems, national laws or regulations.

The following structure is not to be read as a claim for supremacy of transnational over national laws and regulations. In finance, market participants must resort to state law and state courts. They act autonomously but not independently. This is the case, for example, in insolvency situations the outcome of which is basically determined by national insolvency laws that reflect local public policy objectives. More generally, market participants have to resort to states for contract enforcement. The lex mercatoria of finance is subordinate to the legal orders of states. As summarized by Pistor, financial instruments are in all forms about contractual relations enforceable in a court of law.[135] States continue to remain as the sovereign in their respective geographical territories and transnational law must respect these local laws.[136] As common historical knowledge tells, states can suppress and prohibit any forms of 'private' through legislation and the power of the state. States can abolish all notions of the fundamental principles and even outlaw any forms of private interactions. Regardless of this power, as any black market for private products and service people – for reason or the other – choose to use under the rule of the most oppressive and totalitarian states imaginable, people still engage in repeated interactions (by trading with each other), private normativity still exists and private normative orders are still spontaneously created. In this sense, at least, the fundamental principles are truly inalienable and are not construed and determined by state law.

The transnational legal order can be further construed as a structure consisting of:

(i) fundamental principles manifested in public international law, from the protection of private ownership, transferability of property, and contract, to public policies such as the protection of environment, safety, and health;
(ii) transnational customary laws that are mandatory in their nature not by law but which are still followed in business. They emerge and evolve in commercial practice, like eurobonds and close-out netting, which concern

is linked to a broad-based recognition that human agency is essential to human dignity and that agency in prioritising otherwise incommensurable values is particularly important in securing the conditions for that dignity.

135 Pistor (n 116) 319.

136 Dalhuisen (n 107) 328.

'all that is considered normal by participants on which they commonly rely in their business and markets', and in their routines and perceptions;
(iii) uniform substantive treaty law of mandatory nature as well as financial regulation operating under public international law;
(iv) mandatory general principles such as the notions of good faith in contractual relationships;
(v) standardized contractual terms of private trade organizations;
(vi) customs and practices of private trade organizations that can be found for example from their private rules and recommendations;
(vii) international conventions, if deemed relevant;
(viii) general principles of the particular legal structures or relationships common to leading legal systems, and ultimately the national law applicable defined through conflict of law rules; and, finally
(ix) local national laws identified through the most appropriate conflict of laws rules.[137]

It is not a new finding that those who agree that transnational law is essentially about private normativity are undecided about its hierarchy and relative importance of its sources.[138] The purpose of this hierarchy is to lay out a mental map to demonstrate that in many cases and situations there are no other laws available than fundamental principles of private property, transferability of the same, and binding contracts. Through repeated interactions, *transnational customary law* can emerge like it did in the eurobond market as further discussed in Chapter 3. Perhaps the most challenging task (a task that falls outside the scope of this research) is to find a place for transgovernmental regulators briefly discussed in Chapter 6 in the structure above.

The rules expressed in the ISDA Master Agreement architecture also reflect the transnational customary nature and the market practices OTC derivatives market.[139] Local bankruptcy laws might be becoming more facilitative in recognizing transnational practices also when it comes to the enforceability of bilateral close-out netting.[140] Be that as it may, in the OTC derivatives market, much of the private normativity emerged from repeated interactions between market participants which manifested itself in the form of a standardized contractual terms. Before the 1980s, there was nothing to be put to category (v) above when it comes to OTC derivatives market. Later on, market participants engaged in repeated interactions

137 Dalhuisen (n 107) 218–22.

138 Dalhuisen (n 23) 180–87; Michael Mustill, 'The New Lex Mercatoria: The First Twenty-Five Years' (1988) Arb.Int'l 86, 109.

139 Dalhuisen (n 89) 368–371.

140 Dalhuisen (n 89) 315.

with international regulators (operating under public international law) through which this transnational law of the OTC derivatives market, the contractual right to use bilateral close-out netting, became even codified in many jurisdictions. In the EU, this took place through national transposition of EU Directives as further discussed in Chapter 5.

Many aspects of finance take place without the sources of law referred to in categories (ii)–(ix). Take nation states, for example. Nation states have a multidimensional role in finance and in the very creation of transnational law. They are typically stakeholders in the financial institutions located in their respective jurisdictions. States also finance themselves in the international capital markets and have played an important role in the formation of the OTC derivatives market in general, from individual products to the regulatory recognition of private regulatory mechanisms, as also discussed in Chapters 3 and 5. Nation states have played also an unintentional role as facilitators. State-made laws and regulations have given rise to many forms of legal innovations that are not caught by existing national regulatory barriers. Eurobonds were created for this purpose, as were swap structures. Furthermore, nation states can default on their debt, but unlike private market participants, they cannot be declared bankrupt. In the capital markets, sovereign issuers issue debt to finance their public projects, and they have much power over issues like taxation, expenditures, and control over the money supply. If a corporation defaults, it can disappear from existence, whereas a nation state cannot.[141] Importantly, '[t]here is no international bankruptcy law for sovereign states and therefore the outcomes are determined by the bargaining position of the parties and free agreement'.[142] In other words, besides the fundamental principles referred to in category (i) above, in some cases there is not much other law available than transnational law when a state defaults on its debt.

The Herstatt bankruptcy example discussed in subchapter 2.11 demonstrates that transnational financial institutions can operate and find legal solutions to highly complex and sensitive legal problems without the sources of law referred to in (ii)-(ix). For any other absent sources of law, beyond fundamental principles, these financial institutions had to rely on the implicit fundamental principles, the creation of a private contract, and its enforceability in a national court. The legal risk arising from national laws created an incentive for these private financial institutions to find a transnational solution to a transnational legal problem. This is not an isolated event and example of actual and verifiable transnational normativity. The same applies to the emergence of the eurobond market, as well as to the invention of

141 Panayiota Koulafetis, *Modern Credit Risk Management. Theory and Practice* (Macmillan Publishers Ltd 2017) 97.

142 Philip R Wood, 'How the Greek Debt Reorganisation of 2012 Changed the Rules of Sovereign Insolvency' (2013) 14 Bus. L. Int'l 3, 13.

bilateral close-out netting in the OTC derivatives markets, not to mention the Greek debt crisis involving credit default swaps and their interpretation in 2012. Market participants operated largely on the basis of fundamental principles since virtually no other law is available. Gradually, transnational law gained recognition from international organizations and some aspects of customary transnational law turned even into 'hard law' whereby national parliaments made transnational practices the official law of the land. To understand codified legislation and financial regulation, it is often necessary to know about their transnational origins. It is very challenging to put the interactions between private normativity and financial regulation into a legal theoretical framework given the esoteric nature of the latter. However, it is important, which is why it is attempted in the following subchapters.

2.11 INTERACTIONS BETWEEN PRIVATE NORMATIVITY AND FINANCIAL REGULATION

2.11.1 HERSTATT RISK REVISITED: TRANSNATIONAL INSOLVENCY TRIGGERS INTERNATIONAL COOPERATION FOR FINANCIAL REGULATION

Without the existence of any other law, the fundamental principles and the enforcement of a private contract by a state court were enough to solve probably the most complex legal question that arose in finance in the 1970s. On 26 June 1974, one of the largest German banks, Bankhaus I.D. Herstatt K.G.a.A (Herstatt) was closed and placed into liquidation at 3:30 P.M., Cologne time, in the Federal Republic of Germany by the German Federal Supervisory Authority for Credit Matters (*Das Bundesaufsichtsamt für das Kreditwesen*). All payments by Herstatt stopped immediately upon being declared bankrupt.[143] To briefly summarize the preceding events, Herstatt had entered into futures trades under which it suffered great losses following the currency fluctuations in the 1970s. Herstatt's worsening economic condition was rumoured as early as 1971, and despite the cascading rumours and tangible evidence, the German regulators chose not to act, which is why the case is known also as an example of both regulatory, in oversight and supervisory responses, and self-regulatory, in internal risk management, failure. Other German financial institutions did not come to aid, let Herstatt fail, and finally it was declared insolvent.[144] However, it is not the liquidation of Herstatt that brought

143 Chris O'Malley, *Bonds Without Borders: A History of the Eurobond Market* (John Wiley & Sons, Inc 2014) 55.

144 Kurt H Nadelmann, 'Rehabilitating International Bankruptcy Law: Lessons taught by Herstatt and Company' (1977) 52 N.Y.U. L. Rev. 1, 2–3; the preceding events have been described in detail in Emmanuel Mourlon-Druol, 'Trust is good, control is better': The 1974 Herstatt Bank Crisis and its Implications for International Regulatory Reform' (2015) 57 (2) Business History 311.

the concept of 'Herstatt risk' to the vocabulary for decades to come but one of its consequences involving one bank account in the State of New York, US.

Chase Manhattan Bank, N.A.'s (Chase) held a bank account of Herstatt in New York, but Herstatt did not conduct, and had not conducted, any business nor have any other presence in the US. At about 10:30 A.M. US time, the news of the Herstatt liquidation reached Chase in NY. Maybe in order to protect its own solvency and itself from potential claims in this unique situation, Chase suspended all outgoing US dollar payments from the Herstatt account, holding over $150 million, which effectively meant that Chase did let the incoming payments in foreign currencies to be credited to the Herstatt account, until the closing of the business day in New York, but did not pay the counter values in dollars to the would-be creditors of Herstatt. In practice, this meant that Chase received payment instructions from various market participants but did not act in accordance with them.[145] In other words, those market participants requesting Chase to credit the Herstatt bank account had given a payment instruction to Chase to credit the Herstatt account before the other party, Herstatt, had fulfilled its obligation and which was now unable to do so following the liquidation decision. At worst, every unit of foreign currency debited to the Herstatt account could lead to losing the whole principal or at least mean significant delays in recovering the amount from the insolvency estate of Herstatt. The preliminary assumption was that the litigation over the Herstatt account assets could take years. [146]

By the end of the business day, the amount of payment orders and checks seeking to debit the Herstatt account rose to according to one preliminary estimate close to $620 million (which in the end came down to approximately $200 million). What followed was 'one of the most extraordinary legal dramas in New York banking history' as the cross-border elements of the situation were so complex and unique to which a solution could not be found from written legislation or legal principles.[147]

First, there was the question of applicability of the United States Bankruptcy Act to the funds on the Herstatt account which could mean that there could be two administrators for the same assets. Second, there was the liquidation process of Herstatt in another country, which in practice necessitated immediate cooperation between the creditors and the liquidator while the legal situation necessitated that the liquidator would *not* enter the US as this could affect the legal status of the Herstatt account and the liquidator himself under US laws.[148] Third, the assets of Herstatt were scattered in Germany and New York and there were virtually no rules, laws, nor directly applicable case law on how to manage even the first

145 O'Malley (n 143) 55.

146 Joseph D Becker, 'International Insolvency: The Case of Herstatt' (1976) 62 A.B.A. J. 1290, 1291, 1291–93.

147 ibid 1291.

148 Joseph D Becker, 'Transnational Insolvency Transformed' (1981) 29 Am. J. Comp. L. 706, 708.

question as to how to deal with a situation where the payment order had been given to a bank situated in a different time zone from the insolvent entity, Herstatt. In contrast, there was a great legal uncertainty arising from the US Bankruptcy Code under which it could be argued that the mere presence of assets in the form of a bank account could constitute a separate bankruptcy estate. This, in turn, would have granted the US trustee powers over assets *wherever located*, including West Germany and consequently, all the assets of Herstatt.[149] Consequently, there would be a trustee in the US and a liquidator in Germany risking a 'turf war' between the two. This legal risk was an incentive for the creditors to reach a settlement between themselves.[150] Every issue at stake involved at least two national legal systems representing different legal traditions among creditors with high interests in the outcome. Despite the difficult conditions and the absence of formal legal rules or regulations, or as some argue because of the lack of the same,[151] over 30 creditors[152] and the liquidator of Herstatt, and many other parties involved could find and agree on a settlement on February 1975 - less than a year from the date when Herstatt was placed into liquidation.[153] The New York court dismissed an earlier petition for the bankruptcy of Herstatt and the remaining funds were soon transferred to the creditors in accordance with the settlement agreement.[154]

Perhaps the origins and details of the concept of 'Herstatt risk' are no longer very well known, but it remains a widely known concept that refers to risks in settlement and clearing. The risk is about a situation where, in a reciprocal situation, one counterparty fulfills its contractual obligation and its counterparty fails to do the same.[155] If Party A owes €100 to Party B, and Party B owes €102 to Party A, and Party A transfers €100 to Party B, the exposure of Party A is €202 towards Party B. Consequently, if Party B does not fulfill its end of the bargain towards Party A, Party A may have lost €202. The amount of time required to carry out a payment in a payment system or to transfer a security from one securities account to another are at the centre of this risk. As the example on the evolution of central securities depositories indicates, as discussed in subchapter 3.6, financial infrastructure grows

149 Ingo AJ Klocker, 'Foreign Debtors and Creditors under United States and West German Bankruptcy Laws: An Analysis and Comparison' (1985) 20 Tex. Int'l L. J. 55, 59–60.

150 Becker (n 146) 1293.

151 Becker (n 148) 709.

152 'Among more than 30 banks, claimants to the account included Morgan Guarantee ($13m), a Swiss subsidiary of Seattle-First ($42.5m), Hesse-Newman of Germany ($39.7m), Citibank ($10m), Svenska Handelsbanken ($7m). About 3000 creditors made claims on Herstatt'. Mourlon-Druol (n 144) 327.

153 Becker (n 148) 710; as to the liability of the management of Herstatt for the bank failure, HR Dissman, 'The Obligations and Liabilities of Directors and Officers of Companies and Their Protection by Insurance – Germany' (1981) 9 Int'l Bus. Law. 421. The management had entered into forward positions that caused losses and led to the bankruptcy of Herstatt. The German court dismissed the claim against the management as it was difficult to establish any personal liability, 422–23.

154 Nadelmann (n 144) 10–11.

155 European Central Bank (n 84) 115–30.

from market demand and states can facilitate the use of such innovations through legal recognition and enforceability. Financial technology has advanced greatly since the 1970s. The issue of how to manage the related legal risks in new technological environments has been a challenge ever since.[156]

2.11.2 THE AFTERMATH OF HERSTATT

As described in subchapter 2.10.3, financial regulation comes in third place in the hierarchy of transnational legal order after the fundamental principles and transnational customary laws. Many of the interactions between transnational law and private normativity are about the interactions between ISDA and the Basel Committee. The Herstatt case acted as a catalyst for international co-operation. After Herstatt, central bankers saw a demand for international supervisory co-operation and coordination between national regulators and a division of labour between home and host state regulators of transnational financial institutions.[157] Following the meeting of the Governors of the Group of Ten (G10[158]), the Basel Committee was established in 1974 under the Bank for International Settlements,[159] to meet such demands and to address such problems as those that were recognized in connection with the Herstatt liquidation.[160]

The catalyst for the first Basel Accord (Basel I) was the 1982 international debt crisis which was followed by lengthy negotiations between the members of the Basel Committee on Banking Supervision;[161] the initial purpose of which was to search

156 Richard Dale, 'Derivatives clearing houses: the regulatory challenge' (1997) 12 J.I.B.L. 46, '[t]hese systems constitute an extraordinarily complex chain of financial flows and resulting credit interdependencies that I dare say nobody fully understands' 48; Mark Hsiao, 'Finality Orders in the Clearing System and OTC Derivatives Regulation in Hong Kong' (2013) 43 Hong Kong L. J. 139, describing the payment-versus-payment system as a private solution to the Herstatt risk in modern technological framework, 151–52; for the potential impact of new technologies on clearing and settlement, Alexis Collomb, Klara Sok, 'Blockchain/Distributed Ledger Technology (DLT): What Impact on the Financial Sector?' (2016) 103 Communications & Strategies 93.

157 Janet Austin, 'The Power and Influence of IOSCO in Formulating and Enforcing Securities Regulations' (2015) 15 Asper Rev. Int'l Bus. & Trade L. 1.

158 Belgium, Canada, France, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, the United States and West Germany, <https://www.bis.org/list/g10publications/index.htm> accessed 1 June 2019.

159 The BIS itself was established in 1930 to deal with reparation payments imposed on Germany by the Treaty of Versailles following the First World War. Being both a limited-liability company incorporated under Swiss law and an international organization based on international treaty as well as a cooperative body of national central banks allowing them to 'keep politicians at arms length', the BIS has a distinct nature among international organizations. Gianni Toniolo, *Central Bank Cooperation at the Bank for International Settlements* (CUP 2007) 49–51; O'Malley (n 143) 55.

160 Concordat of the Basel Committee, known at that time as the Committee on Banking Regulations and Supervisory Practices, 'Report to the Governors on the supervision of banks' foreign establishment' (26th September 1975) BS/7544e <https://www.bis.org/publ/bcbs00a.pdf?noframes=1> accessed 1 June 2019.

161 Helleiner (n 125) 237.

indicators for future banking crises as well as simply compiling a list of regulators in other countries. Reaching international standards was slow and gradual, but nevertheless it represented a multilateral approach to financial regulation. Basel I was introduced in 1988. The aim of Basel regulations have since been to harmonize international financial regulation through an emphasis on the assessment of *credit risk*, the risk that the other party to a transaction does not honor its obligations for reason or the other, standardized minimum capital requirements and risk-weighting of assets.[162] Following the collapse of other financial institutions such as Banco Ambrosiano SpA in 1983 and the Bank of Credit and Commerce International in 1992, the Basel Committee continued enhancing the cross-border co-operation and information sharing between national supervisory agencies.[163] In time, Basel I found recognition in the EU through Directives and eventually, through transposition, also in the legal orders of its member states.[164]

A random historical event, in this case the collapse of Herstatt, determined the choice of the initial regulatory path. It has even been claimed that the banking business came to be 'largely about attempts to work around regulations and the resulting growth in nonbank alternatives in the far more complex financial system of today'.[165] These non-bank alternatives are generally referred to as *shadow banking*, which is examined in some detail in the next subchapter since they tell more about the interactions between private normativity, from individual consumers to private financial institutions, and financial regulation. The combination of government deposit insurance and the bailout function, or 'lender of last resort', a function of central banks to alleviate liquidity problems in financial turmoil, may have led to a situation where financial institutions had less reasons to internalize their costs for a potential failure. The revised Basel Accord (Basel II) was introduced in 2004, which added new risk categories, including legal risk, to the requirements on supervised entities. Post-GFC analysis reveals that these regulatory measures were slow-moving and failed to provide a clear warning about the upcoming global financial crisis.[166] Financial regulation of the OTC derivatives market returns in

162 Marc Levinson, 'Faulty Basel: Why More Diplomacy Won't Keep the Financial System Safe' (2010), 89 Foreign Aff. 76, 77–80; Koulafetis (n 141) 2:

> Credit risk can be defined as the risk of financial loss due to the borrower's, bond issuer's or counterparty's (the "obligors") failure to honour their financial obligations. The obligor's failure to honour their obligations can arise due to inability or unwillingness.

163 Anu Arora, 'The global financial crisis: a new global regulatory order?' (2010) 8 J.B.L. 670, 676–77.

164 Federico Torzo, Peter Scherer, 'The capital treatment of credit derivatives in Europe' (1999) 14 J.I.B.L. 144, 145–46.

165 Gary Gorton, Andrew Metrick, 'The Federal Reserve and Panic Prevention: The Roles of Financial Regulation and Lender of Last Resort' (2013) 27 The Journal of Economic Perspectives 45, 56.

166 ibid 57; Dalhuisen (n 89) 718–720; Bezhad Gohari, Karen E Woody, 'The New Global Financial Regulatory Order: Can Macroprudential Regulation Prevent Another Global Financial Disaster?' (2014–2015) 40 J. Corp. L. 403, 426–28.

Chapter 6. In this Chapter, however, it is already useful to highlight the interactions and interconnections between finance and financial regulation.

2.12 STATES CREATED SHADOW BANKING

According to *Adam J Levitin*, shadow banking is not a product of organic evolution of the financial market but more of an outcome or a sideproduct of financial regulation.[167] Essentially, shadow banks serve the same purpose as commercial banks. Like commercial banking, shadow banking has a function that can be characterized as lending, and likewise like commercial banking, shadow banking has a deposit function. Instead of deposits like in commercial banking, investors invest in the financial products offered by a shadow bank which they can withdraw similarly to how they can withdraw their deposits. Regulatory capital requirements set a low-risk weight for most of shadow banking products, from repurchase agreements to swaps and many others, which incentivizes their use and conveys a signal that these products are somehow safe, even when they necessarily are not. [168] Shadow banking is interlinked to the global financial crisis of 2008.[169]

According to *Roberta Romano*, the global financial crisis can be attributed, not necessarily decisively, to a situation where many withdraw their investments simultaneously, a phenomen generally known as a *bank-run*, in the shadow banking sector. Similarly, to how everyday consumers can withdraw their deposits simultaneously and consequently cause problems for a bank, when many market participants do this, liquidity problems can arise in many interlinked markets especially when many own each other with short-term debt. In essence, one cannot fulfill their contractual obligations to pay someone else if a counterparty fails to pay the former, which can lead to a cascade of defaults. It is common to focus on the actions of private entities as the creators of shadow banking and *regulatory arbitrage* discussed in subchapter 3.5.3, bypassing of existing rules whereby a financial institution can reduce the amount it holds regulatory capital while maintaining the same level of exposures, as its motivation.[170] The fact that shadow banking is a side product of financial regulation itself seems not to be an issue. The

167 Adam J Levitin, 'Safe Banking: Finance and Democracy' (2016) 83 U. Chi. L. Rev. 357 357, 364.

168 ibid 379–407.

169 Robin Greenwood, David Scharfstein, 'The Growth of Finance' (2013) 27(2) The Journal of Economic Perspectives, 3, 6; Financial Stability Board, 'Shadow Banking: Scoping the Issues A Background Note of the Financial Stability Board' <http://www.fsb.org/wp–content/uploads/r_110412a.pdf> accessed 1 June 2019; Shen Wei, 'Demystifying Shadow Banking in a Bank-Centric Paradigm: A Comparative Approach' (2017) 33 B.F.L.R. 1, discussing the ambiguity of the concept, 2–3.

170 Kristin N Johnson, 'Macroprudential regulation: a sustainable approach to regulating financial markets' (2013) U. Ill. L. Rev. 881, 902–06, 914–18.

discussion revolves around how to make more or shape existing financial regulation to reduce *systemic risk*, a problematic concept discussed in subchapter 6.4.[171]

According to *David Ramos Muñoz*, shadow banking should not be viewed as a parallel financial system to regulated banking. Instead, shadow banking *is* the financial system we have, and the role that legal institutions play in its creation should be investigated more.[172] In addition, rather than being somehow invisible or in the shadows to regulators, these nonbank financial shadow banking entities interact with regulated institutions and are visible to the same.[173] The reason why many Basel-regulated financial institutions held non-performing assets was that Basel II incentivized them to do so by giving such assets a lower regulatory risk-weighting than the actual credit risk of the products. Financial regulation contributed to the creation of the GFC.[174] Romano criticizes that post-GFC, the regulatory response has been to continue the failed strategy adding further to the complexity without offsetting benefits.[175] According to *Levon Garslian*, '[o]ne thing is clear: the origin of the [GFC] lay not in the derivatives market, but in the economic imbalance created by the "defective" mortgages,' and the excessive amount of opaquely rated credit default swaps sold on these assets.[176]

From where do these defective mortgages and other assets originate? And how does consumer action interact indirectly with financial regulation and the OTC derivatives market? To put the questions into a historical context, during the last half of the 1970s, borrowing accelerated on all levels of western societies and changed the behaviour of corporates, governments, and individuals, which in turn created a demand for new types of business from groups of financial intermediaries to new types of securities. The growth of finance can be especially associated with two activities: asset management and household credit. Asset management brought benefits in that it opened new investment opportunities for customers

171 As it does in, for example, Christina Parajon Skinner, 'Whistleblowers and Financial Innovation' (2016) 94 N.C.L. Rev. 861, 868–873; Ross P Buckley, 'Reconceptualizing the Regulation of Global Finance' (2016) 36 Oxford J.Leg.St. 242; Anita I Anand, 'Is Systemic Risk Relevant to Securities Regulation?' (2010) 60 U. Toronto L.J. 941, 947; Emilios Avgouleas, 'The global financial crisis, behavioural finance and financial regulation: in search of a new orthodoxy' (2009) 9 J. Corp. L. Stud. 23.

172 David Ramos Muñoz, 'Shadow Banking: The Blind Spot in Banking and Capital Markets Reform' (2016) 13 Eur. Company & Fin. L. Rev., 157.

173 Anat R Admati, 'The Compelling Case for Stronger and More Effective Leverage Regulation in Banking' (2014) 43 The Journal of Legal Studies 35, 55.

174 Roberta Romano, 'For Diversity in the International Regulation of Financial Institutions: Critiquing and Recalibrating the Basel Architecture' (2014) 31 Yale J. on Reg. 1, 8–19.

175 ibid 23; Chapter 6.

176 Levon Garslian, 'Towards a universal model regulatory framework for derivatives: Post-crisis conclusions from the United States and the European Union' (2015–2016) 37 U. Pa. J. Int'l L. 941, for an overview of OTC derivatives regulation prior to 2008 in the US and the EU, 941, noting that both lacked 'a comprehensive regulatory framework prior to the 2008 financial crisis,' and noting that there is no consensus among experts as to the impact of OTC derivatives on the global economy in 2008, 969–71, 976.

and simultaneously facilitated access to diversified capital for corporations which, through increased supply of money, also likely lowered the cost of capital. On the other hand, the better access might lead to overinvestment to certain industries. As to household credit, wider access to capital could also mean overinvestment and excess consumption in relation to income.[177] For consumers, the availability of household credit meant the possibility to extend the maturity of their mortgages and consumer spending loans, and the ability to divert available cash into further consumer spending. It was a public policy objective to make capital more readily available to consumers.[178] Consumer credit cards were a driver for more convenient payment methods and of course generated business to the issuers, gave access to new financing methods, and, at least in some segments, led to higher risks of default and social ills.[179] At the same time, bank de- and reregulation that followed from technological advancement decreased income inequality especially among the poor.[180] The role public policies play in issues like homeownership have a clear systemic impact for the whole financial system which is why this aspect should not go unnoticed in scholarly research.[181] As consumer credit and financial intermediation are connected also to the OTC derivatives industry, it is beneficial to identify some of their attributes in more detail to further highlight the interlinkages between seemingly unrelated markets. This all relates to a much larger topic of ‘democratisation of credit’ and of the credit culture we live in.[182] However, these are not central for the purposes of theoretically construcing the transnational law of the OTC derivatives market which is why the impact of culture promoting of living beyond one’s means is only mentioned here. Shadow banking is the creation of states.

177 Robin Greenwood, David Scharfstein, ‘The Growth of Finance’ (2013) 27(2) The Journal of Economic Perspectives 3, 5–6.

178 Stephen A Cowan, Susan E Foley, ‘New Trends in Residential Mortgage Finance’ (1978) 13 Real Prop. Prob. & Tr. J. 1075; David M Darst, *The Handbook of the Bond and Money Markets* (McGraw-Hill, Inc 1981) 16–17; Peter W Salsich, ‘Homeownership - Dream or Disaster?’ (2012) 21 Journal of Affordable Housing 17.

179 Sandra E Black, Donald P Morgan, ‘Risk and the Democratization of Credit Cards’ June 25, 1998 <https://www.newyorkfed.org/medialibrary/media/research/staff_reports/research_papers/9815.html> accessed 1 June 2019.

180 Thorsten Beck, Ross Levine, Alexey Levkov, ‘Big Bad Banks? The Winners and Losers from Bank Deregulation in the United States’ (2010) LXV 5, The Journal of Finance 1637.

181 U.S. House of Representatives Committee on Oversight and Government Reform ‘The Role of Government Affordable Housing Policy in Creating the Global Financial Crisis of 2008’ describing the political objective that was backed by flawed and minimal evidence of increasing homeownership rate among low- and moderate-income families; the history of the public policy of affordable housing dates back to at least to the latter half of the 1970s, Dalhuisen (n 89) 547, n 178.

182 Dalhuisen (n 89) 547–554, 612–15.

2.13 SHADOW BANKING AND CREDIT DERIVATIVES

Following the surge in consumer spending for goods and services that apparently fulfilled some subjective consumer need, one new and still a very common method of redistributing credit and other types of risk was, and still is, *securitization*. In short, credit risk means that a counterparty to a transaction does not meet its obligation when due and will not meet that obligation for full value, or even more simply put, the risk of loss if the counterparty does not pay when the counterparty is supposed to pay. Regardless of the type of transaction, it involves credit risk from deposits to loans and from bonds to derivatives.[183] In the simplest terms, securitization refers to the assignment of an asset, for example a mortgage, to parties willing to bear the risk of credit risk. The securitizing financial entity, the originator, receives cash that the originator can use elsewhere, from the investors who buy the debt securities backed by a cash flow originating from mortgage installations. The cash flow, amortization of a mortgage, is tied to the debt securities, and the parties who have taken the risk of non-payment are the investors: if the debtor-consumers will not pay, the investors lose, and not the financial institution-originator who had originally granted the loans to the consumers now in default.[184]

In its synthetic form, the originator does not assign the actual asset but transfers the underlying risk, thus in this case, the risk of the non-payment by the aforementioned consumer.[185] Securitization requires much legal structuring.[186] Until 2007, academic literature may have ignored the in-depth analysis of credit derivatives used in securitizations.[187] This structure involves the use of credit derivatives made under the ISDA MA architecture.[188] Underpricing of risk in the

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183 Koulafetis (n 141) 3–11.

184 Mortgages are a popular debt type for securitization, but generally any type of asset can be securitized as long as the legal ownership of the asset can be assigned, the asset generates predictable cash flows and there is historical data available as to quantify the credit risk, non-payment risk, of the asset, Markus Krebzs, *Securitization and Structured Finance Post Credit Crunch: A Best Practice Deal Lifecycle Guide* (Wiley 2011) 75–76.

185 For synthetic securitizations, Bob Penn, 'Banking Regulation' in Paterson, Zakrzewski (n 114) 93–94; for securitizations, Geoff Fuller, 'Loan Transfers, Securitisation, and Structured Finance' ibid, 693–95; for a critical view, Oskari Juurikkala, *The Law and Economics of Credit Default Swaps. Derivatives Regulation, Insurance Law, and Recent Financial Market Reforms* (Faculty of Law, University of Helsinki 2015); Oskari Juurikkala, 'Financial Engineering Meets Legal Alchemy: Decoding the Mystery of Credit Default Swaps' (2013–2014) 19 Fordham J. Corp. & Fin. L. 425.

186 For an end-user perspective on how transactions were structured, Craig W Murray, 'The Oil and Gas Lawyer's Role in New Financing Techniques' (1995) 42 Ann. Inst. On Min. L. 44.

187 Frank Partnoy, David A Skeel Jr, 'The Promise and Perils of Credit Derivatives' (2007) University of Pennsylvania Law School, Faculty Scholarship Paper 1019, 1021 <http://scholarship.law.upenn.edu/faculty_scholarship/119> accessed 1 June 2019; Steven Edwards, 'The law of credit derivatives' (2004) J.B.L. 617, noting also the negative regulatory attention this market attracted relatively early on.

188 Krebzs (n 184) 125; Houman B Shadab, 'Guilty by Association - Regulating Credit Default Swaps' (2010) Entrepreneurial Bus. L.J 407, 422–24.

mortgage market spread from securitizations, and, from there, to the credit default swap market.[189] With an absence of standardized terms in the collateralized debt obligation market, market participants drafted and customized contractual terms, and innovated new financial structures to facilitate securitizations. Already before the global financial crisis of 2008, it was clear for some that the size of the credit risk would not be adequately captured by existing standardized contractual terms or that the arrangements could lead to transfer of risks other than credit risk, the risk that a CDS is supposed to transfer, in the market.[190]

Some market participants knew and understood more about these interlinkages which paved the way for considerable informational asymmetries between dealers and end-users on the one hand and on the other also between public and private sectors more generally. Some knew more than the others.[191] In the aftermath of the GFC and in the hundreds of litigations that ensued, numerous court scrutinies revealed that the terms and conditions of many of these structured transactions had been drafted poorly, and in an inconsistent or even in a contradictory manner.[192] While commoditization of risk through securitization generally allows better access to funding, financial engineering had become excessive in many respects before the 2008 financial crisis.[193]

Aside from the economic benefits, what other drivers were there to engage in the securitization business? One answer is that regulators created an incentive to do so. According to *James S Barth* and others, the Basel Committee recommended the use of securitization and allowed securitized assets to have a lower capital requirement than loans. In hindsight, the incentive was distorted and created an incentive for structurally unregulated products. In earlier times banks knew the credit standing of their customers but this apparently became harder once there were no longer individual mortgages but bundles of co-mingled mortgages from which the actual credit risk was difficult to determine. A uniform set of regulations reflecting political compromises made the whole financial market subject to systemic risks.[194] One reason is that the market transformed from personal (from creditor

189 Shadab (n 188) 415–16.

190 Ian Sideris, Simon Puleston Jones, 'How to Adapt ISDA Documents for CDOs' (2005) 24 Int'l Fin. L. Rev. 78

191 Anita I Anand, 'Is Systemic Risk Relevant to Securities Regulation?' (2010) 60 U. Toronto L.J. 941.

192 Rachel Evans, 'Inscrutable, Ambiguous and Inconsistent' (2008) 27 Int'l Fin. L. Rev. 28

193 Dalhuisen (n 89) 473–77; For a comprehensive overview and review, Financial Crisis Inquiry Commission, 'Financial Crisis Inquiry Report, The, 'final report of the national commission on the causes of the financial and economic crisis in the United States' (January 2011) Official Government Edition <https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf> accessed 1 June 2019.

194 James R Barth, Gerard Caprio Jr, Ross Levine, *Guardians of Finance – Making Regulators Work for Us* (The MIT Press 2012) 51–54; Philip Rawlings, Andromach Georgosouli, Costanza Russo, 'Regulation of Financial Services: Aims and Methods' (2014) Centre for Commercial Law Studies, Queen Mary, University of London, 54–55, <http://www.ccls.qmul.ac.uk/docs/research/138683.pdf> accessed 1 June 2019. For a summary of common type of criticism, Arthur E Wilmarth, Jr, 'Turning a blind eye: why

to known debtors), to impersonal (from creditor to a pool of unknown debtors).[195] In addition, since credit derivatives allowed lender banks to transfer the credit risk instantly away from themselves to other parties, lending standards deteriorated while the credit derivative sellers lacked the capability to properly monitor the ability of borrowers to repay their loans.[196]

At least one research team suggests that financially constrained borrowers and lenders may have an incentive to collude to overvalue the collateral of mortgages in order to receive and grant larger loans.[197] Importantly, the information about the risks of the collateralized bonds were disclosed to the investors in advance, save for the size of the drop in home prices that very few anticipated, but the sheer amount of information required by prospectus regulations made it to some extent 'akin to the difficulty that would be posed by searching the Internet without a search engine to systematically filter through and organize results'.[198]

The Basel Committee, as an institutional choice, is cemented to the international financial regulatory framework in a manner that might have prevented and might continue to prevent the emergence of perhaps more efficient alternative forms of financial regulation.[199] The power and weight of tradition of doing things is not limited to the Basel Committee but has been observed also in other areas.[200] According to *Pierre-Hugues Verdier*, financial regulation will continue to be shaped by three actors: the financial regulators, the financial industry, and great power governments, that each have their own reasons not to change the existing regulatory framework.[201] Similarly, *Anat R Admati* views the issue of ineffective regulation as a policy choice:

> [a] key reason for the repeated failure to implement effective regulation is the politics of banking. Banks are as fragile as they are because they want to be and because policy makers often see benefits to themselves

Washington keeps giving in to Wall Street' (2012–2013) 81 U. Cin. L. Rev. 1283, 1329–1340.

195 Adam J Levitin, 'The Crisis without a Face: Emerging Narratives of the Financial Crisis' (2009) 63 U. Miami L. Rev. 999, 1009–1010.

196 Moorad Choudhry, *Structured Credit Products: Credit Derivatives and Synthetic Securitisation* (2nd edition, John Wiley & Sons, Inc 2010) 2. For one summary of contributing causes to the GFC, ibid 9–15.

197 Sumit Agarwal, Itzhak Ben-David, Vincent Yao, 'Collateral Valuation and Borrower Financial Constraints: Evidence from the Residential Real Estate Market' (2012) NBER Working Paper Series 19606. National Bureau of Economic Research, Cambridge, MA <http://www.nber.org/papers/w19606.pdf> accessed 1 June 2019.

198 Steven L Schwartz, 'Regulating Complexity in Financial Markets' (2009) Wash. U. L. Rev. 211, 222 <http://openscholarship.wustl.edu/law_lawreview/vol87/iss2/1> accessed 1 June 2019.

199 Lucia Quaglia, The European Union and Global Financial Regulation (OUP 2014) 35, 43, 55.

200 Rawlings and others (n 194) 14.

201 Pierre-Hugues Verdier, 'The Political Economy of International Financial Regulation' (2013) 88 Ind. L.J. 1405, 1457–59.

> (or to other causes) from tolerating, and at times even encouraging, this fragility and have little to gain from challenging it.[202]

Whatever the legal theory one chooses to use, it should be able to somehow capture the private normativity aspects and interactions between finance, financial regulation, legislation, and even consumer behavior. The concept of transnational legal ordering could be the way forward and a case study on the evolution of the eurobond market discussed in the next Chapter could be illustrating in this regard.

202 Admati (n 173) 55.

3. TRANSNATIONALISATION AND MARKET LIBERALIZATION

3.1 MARKET LIBERALIZATION CAME AFTER THE EUROBOND MARKET

> The words 'regulation' and 'deregulation' are not absolute goods and evils, nor are they meaningful policy prescriptions[1]

Financial regulation can be understood to mean 'any *state influence* on business conditions and behaviour patterns of financial institutes on the financial market'.[2] Following this working definition, state laws are a form of financial regulation since they demonstrably influence the business conditions and behaviour patterns of financial institutions or those working in them. In the words of *Panayiota Koulafetis,* '[f]inancial intermediaries have always been regulated', and due to state intervention, in the form of bailouts and nationalizations of financial institutions, their regulation has changed significantly.[3] Financial liberalization is perhaps a vague but still a necessary umbrella term that helps to contextualize this research. Private normativity can flourish in illiberal market conditions. Financial liberalization and its systemic implications have been studied by many from different angles and there is evidence regarding its benefits and downsides in the short and long term in different countries.[4] It is generally understood as a set of gradual and interlinked processes consisting of various economic reforms carried out in different states at different times.

The following three-part categorization has been used by *Graciela Laura Kaminsky* and *Sergio L Schmukler* in their research on the evolution and impact of the same on nation states.[5] First, there is the category of opening up of the *capital*

1 Tom Davis, former U.S. congressman for the State of Virginia, III US House, Committee on Oversight and Government Reform, The Financial Crisis and the Role of Federal Regulators, Hearing before the Committee on Oversight and Government Reform, October 23, 2008 <https://www.gpo.gov/fdsys/pkg/CHRG–110hhrg55764/html/CHRG–110hhrg55764.htm> accessed 1 June 2019.

2 Alexander Wellerdt, *Organisation of Banking Regulation* (Springer International Publishing 2015) 27 (emphasis added).

3 Panayiota Koulafetis, *Modern Credit Risk Management. Theory and Practice* (Macmillan Publishers Ltd 2017) 1.

4 Rizwaan Jameel Mokal, 'Liquidity, systemic risk, and the bankruptcy treatment of financial contracts' (2015–2016) 10 Brook. J. Corp. Fin. & Com. L. 15, 24–27.

5 Graciela Laura Kaminsky, Sergio L Schmukler, 'Short-Run Pain, Long-Run Gain: Financial Liberalization and Stock Market Cycles' (2008) 12 Review of Finance, Oxford University Press for European Finance Association 253, noting, 280:

> [t]here is consensus that at the core of the link between crises and liberalization is the lack of good public and corporate governance and the existence of weak government policies and institutions.

account liberalization. This is essentially the freedom for banks and corporations to borrow freely abroad without first addressing national regulatory requirements. In other words, what is typically deregulated are the exchange controls that outright prohibit or limit borrowing to and from either abroad.[6] Capital controls include restrictions on capital inflows and outflows from one state to another. The ratio of the former for states is to reduce domestic dependence on foreign capital as well as to protect itself from the *boom-bust cycle* discussed in subchapter 6.2 by discouraging foreign investors from entering the market and overflowing the domestic market with foreign capital. In turn, restrictions on outflows of capital are to prevent foreign investors from exiting the domestic market. There are many ways to prevent these flows, but regulations often '[c]reate perverse incentives and other inefficiencies, and may worsen, instead of prevent, such [financial] crises'.[7]

As evidence from the eurobond market suggests, exchange controls had limited impact in hindering lending to and from abroad. According to research by *Dennis P Quinn* and *A Maria Toyoda*, capital account openness was in a steady decline from 1958 until the late 1970s when measured by the existence and severity or magnitude of restrictions on capital outflows and inflows.[8] Second*, liberalization of the domestic financial sector* may refer to deregulation of domestic controls on interest rates or controls on credit allocation. This could be summarized to refer to the level of state control on the formation of interest rates and the requirement for private institutions to subsidize or otherwise favour certain domestic industries over foreign industries. Third, *deregulation of the stock market* which refers to a regulatory environment where foreign investors are allowed to hold equity, shares, in domestic corporations.[9] Typically, none of the three measures can be pinpointed to any specific date or occurrence, whether that be the signing of an international treaty or the enactment of state legislation with the policy objective of unhindered

6 IMF Articles of Agreement, Article VIII, section 2(b):

> Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member.

In the US, courts adopted a wider definition of what constitutes an 'exchange contract' whereas in continental Europe, courts adopted narrower definitions. This led to divergence and regulatory arbitrage already in the 1960s. Jody Daniel Newman, 'Exchange Controls and Foreign Loan Defaults: Force Majeure as an Alternative Defense' (1985–1986) 71 Iowa L. Rev. 1499, 1509–15.

7 Frank Partnoy, 'Financial Systems, Crises, and Regulation' in Niamh Moloney, Eilís Ferran, Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (CUP 2013) 88–89.

8 Dennis P Quinn, A Maria Toyoda, 'Does Capital Account Liberalization Lead to Growth', The Review of Financial Studies (2008) 21 (3) 1403, 1410:

> [T]he 1960s through the early 1980s, in contrast, were characterized by a retreat from international financial openness. The closure from 1961 to the early 1980s was accompanied by decreases in the annual standard deviation of CAPITAL [an indicator used by Quinn and Toyoda]: during this period, *it was financial closure, not openness, that spread worldwide.* (emphasis added)

9 For the impact on business models generally, Peter Norman, *Plumbers and Visionaries: Securities Settlement and Europe's Financial Market* (Wiley 2008).

movement of capital or deregulation of existing regulation preventing the same.[10] Kaminsky and Schmukler note that the findings in this research area are often inconclusive and at least prima facie conflicting while they often share the same research point of departure, the capital markets.[11] This dissertation also has capital markets, the eurobond market, as its point of departure followed by legal analysis of the over-the-counter (OTC) derivatives market. Linking capital markets with the OTC derivatives market from a legal perspective can potentially complement existing economic research by offering a legal description on how the financial sector changed, grew, and what social benefits and costs it may have brought with it.[12]

The relevance of this pre-liberalization era for this research is that this development led in part to the emergence of the OTC derivatives markets. This market saw its modern emergence and exponential growth in the 1980s together with other financial innovations. The evidence is clear: inflows and outflows of capital were common and grew exponentially *regardless* of the outright prohibition and limitations on capital movements and even criminal sanctions on the same. Financial institutions and corporations still borrowed and lent abroad, raised capital from and invested in international bond markets and invested in foreign companies prior to these areas being liberalized or deregulated in the aforementioned meaning. Further, the evidence suggests that this was also the time of great financial innovation both in the financial product range offered, the emergence of financial infrastructure still used to date, and the rise of what is commonly referred to as transnational corporations. This is all the more interesting as Kaminsky and Schmukler refer to outright prohibition to borrow abroad as the most extreme form of restriction on capital movements which were common during the pre-liberalization era.[13]

The general regulatory environment before that can be roughly summarized as follows. As to the capital account, banks and corporations were not allowed to borrow abroad, there were special exchange rates in force set by states, and there were restrictions on capital outflows in that any transfer of capital from one state to another were often prohibited. The domestic financial sector was subject to controls in lending and borrowing rates, certain areas were subsidized over others preventing the free allocation of capital, and deposits in foreign currencies were prohibited. In

10 Kaminsky, Schmukler (n 5) 265–66. For a literature overview in economics, Luuk Elkhuizen, Niels Hermes, Jan Jacobs, Aljar Meesters, 'Financial development, financial liberalization and social capital' (2018) 50 (119) Applied Economics, 1268, 1269–70, < https://www.rug.nl/research/portal/files/54201649/Financial_development_financial_liberalization_and_social_capital.pdf> accessed 1 June 2019.

11 Kaminsky, Schmukler (n 5) 254–55.

12 Robin Greenwood, David Scharfstein, 'The Growth of Finance' (2013) 27(2) The Journal of Economic Perspectives, 3. Greenwood and Scharfstein calculate that in the US the value-added share of GDP of financial sector between the 1950s and the 1980s grew from approximately 2.8 per cent to 4.9 per cent. In their calculation, the definition of 'finance sector' includes insurance, securities, and credit intermediation subsectors, 3–4.

13 Kaminsky, Schmukler (n 5) 259.

the stock market, foreign investors were not allowed to hold domestic equity, and even if they were, there were limitations as to how to repatriate capital, dividends, and interest.[14] However, much was still unregulated. For example, it was not until the end of the 1970s when banks established in England became, following a series of bank failures, regulated by the Bank of England through the introduction of the Banking Act of 1979. The emphasis was on self-regulation further endorsed in the 1980s and 1990s by politicians and regulators alike.[15] Nevertheless, from the late 1970s, deposit-taking banking became a licensed activity in the United Kingdom, subject to oversight by the Bank of England and its enforcement mechanisms, including fines, as well as mandatory crisis management.[16] Within the European Community, banking was steadily becoming subject to pan-European financial regulation in the late 1970s and 1980s and this regulatory development can be characterized as being 'revolutionary' in its nature.[17] Banking was hardly an unregulated activity.

A few remarks should be made before moving on to the transnationalisation processes that took place during the pre-liberalization era. Market liberalization did naturally have a significant impact on the earlier pre-liberalization business models. Following liberalization more characteristic of the 1980s, internationally active banks switched their former core business, deposit-taking, lending, and brokerage, to other emerging business areas such as the underwriting business in the capital markets and acting as a dealer between buyers and sellers. In other words, the business was to trade on their own account as a principal rather than on behalf of their clients as the agent.[18] Often this meant that the business model switched from brokerage, thus acting as agents to facilitate trading between buyers and sellers, to acting as a principal with other market participants.[19] At least in some aspects, deregulation in this process was gradual in that while the prohibitive regulations were in force, regulators allowed these activities by interpreting these regulations in a facilitating manner that in turn made it difficult to reregulate new types of business.[20] Also in the OTC derivatives industry, this meant a division between

14 This is a summary of the 'no liberalization' category used in Kaminsky, Schmukler (n 5) 285–89.

15 Philip Rawlings, Andromachi Georgosouli Costanza Russ, 'Regulation of Financial Services: Aims and Methods' (2014) Centre for Commercial Law Studies, Queen Mary, University of London, 12–18, < https://www.qmul.ac.uk/ccls/media/ccls/docs/research/020-Report.pdf > accessed 1 June 2019.

16 Banking Act 1979, Chapter 37.

17 Matthias Haentjens, Pierre de Gioia-Carabellese, *European Banking and Financial Law* (Routledge 2015) 7–9.

18 Robert Weber, 'New Governance, Financial Regulation, and Challenges to Legitimacy: The Example of the Internal Models Approach to Capital Adequacy' (2010) 63 Admin. L. Rev. 783, 805–11.

19 Market liberalization and deregulation is often tied to the reform referred to as the Big Bang in the UK which came into full effect in 1986. In many respects the Big Bang was a move towards formalized deregulation and *reregulation* of areas that were earlier self-regulated. Peter JR Bloxham, 'The Financial Services Act' (1986) 1 I.B.L.J. 73.

20 Saule T Omarova, 'The Quiet Metamorphosis: How Derivatives Changed the "Business of Banking' (2009) Cornell Law Faculty Publications Paper 1021 <http://scholarship.law.cornell.edu/facpub/1021> accessed 1 June 2019.

two types of business: an intermediation service for clients and a dealing function on its own account. The difference, while very significant as to its repercussions in other areas of finance and its legal implications, was not even clear to the market participants themselves.[21]

To summarize, since the future, adaptation and evolution of financial products is unknown, financial regulation is always behind in regulating new products which are by their nature not regulated when they are first introduced in the market. Flows of financial products became gradually deregulated while the market participants became reregulated by their functions.[22] One does not need to go far to find and invest in unregulated financial products traded in the shadow banking sector. Financial innovations can be popular among investors, and despite their popularity, they can remain 'in the regulatory backwater'. For example, the so-called exchange traded funds, or ETF's, are currently the most actively traded financial products in the world and yet they still operate in a regulatory vacuum or in the cracks of existing regulations. [23] A cursory online search reveals that in order to trade ETF's, it requires one to have a proof of identity, a bank account, access to a computer, a standard brokerage agreement, and a minimal amount of disposable funds, to build a portfolio on ETFs. ETF's can be also built with derivative structures as synthetic ETF's.[24]

3.2 ON GOVERNANCE THEORIES AND NARRATIVES

Already in the early 1980s, the general ethos was towards deregulation of those regulations seen as a hindrance to market innovation, and towards co-operation between public and private.[25] Contemporaries of that time were by no means oblivious to the effects that public regulation can have on finance. While these theories are not central for the purposes of this research, they do provide insights as to how the concept *deregulation* is problematic. Deregulation as the primary driver for capital movements was seen early on as a somewhat misleading concept. In the words of *EJ Kane*, who approaches the issue issue from the perspective of

21 Schuyler K Henderson, 'Swap Credit Risk: A Multi-Perspective Analysis' (1988) 44 Bus. Law. 365, 373.

22 Jan Dalhuisen, *Dalhuisen on Transnational Comparative, Commercial, Financial and Trade Law Volume 3 Financial Products, Financial Services and Financial Regulation* (6th edition, Hart Publishing 2016) 490–91.

23 Henry TC Hu, John D Morley, 'A Regulatory Framework for Exchange-traded Funds' (2018) 91 S. Cal. L. Rev. 839.

24 For statistics of ETFs < https://www.londonstockexchange.com/statistics/historic/etf-etp/etf-etp.htm> accessed 1 June 2019.

25 James H Fogelson, 'The World of the '80s – 1980 Annual Meeting Program of the Section' (1981) 37 Bus. Law. 203.

Hegelian dialectics,[26] deregulation 'diverts attention from regulations that are being tightened or left unaltered and from reallocations of regulatory authority', how 'unchanged and tightened restrictions play at least as important role in shaping financial market structures as the particular regulations undergoing relaxation', and, how 'by realigning its organization structure, a financial firm can not only reorganise its regulatory environment, it can also create pressure on legislatures and regulators to rewrite the regulations under which it has to play'.[27] Further, the link between regulation as the driver of innovation seeking to circumvent the same was already apparent during this era as 'in a regulated firm, an innovation can be justified as well, or even instead [of accomplishing a task more efficiently], by its productivity in regulatory avoidance: its ability to release pent-up competitive pressure'.[28]

According to *Jonathan R Macey*, who views regulation from the perspective of *public choice theory*, financial regulation is not shaped by political climate or public opinion. Financial regulation is much more about rather simple incentives and supply and demand for both regulation and deregulation. Public opinion is shaped by the political process, and this process, in turn, is driven by interest group dynamics. Interest groups might favour more regulations, re-regulations and deregulations depending on what relative advantage over their competitors there is on the table. The politician has both the incentive to pass such laws to gain political support and the incentive to claim that the regulations are in the public interest. Thus, it is the interest groups that shape the politician, who in turn convinves the public on the benefits of regulations, re-regulations or deregulations as the case may be. One benefit may be in making a regulation so ambiguous and complicated, that its ramifications are difficult to assess.[29] To contextualize, this

26 Edward J Kane, 'Shadowy Banking: Theft By Safety Net' (2014) 31 Yale J. on Reg. 773, 777; Heikki Marjosola, *Regulatory Governance of EU Financial Markets and Institutions. Dealing with Incompleteness of Law and Constitution* (Faculty of Law, University of Helsinki 2017) noting that while regulatory dialectic grasps the basic governance problem to some extent, '[i]t offers few tools to analyse the problem precisely, let alone ways to mitigate the cycle of unintended consequences by better governance models' 39.

27 Edward J Kane, 'Deregulation and Changes in the Financial Services Industry' (1983) 39 The Journal of Finance, 759, 760, 768; Executive Director of Bank of England, David Walker, 'Some Reflections on Big Bangs in Financial Systems' (1987) 13 CBLJ 388:

> '[the very maintenance of the Glass Steagall restrictions appears to have been enormously influential in encouraging product innovation, the exploitation of legal loopholes and activity abroad, in just the same way as the former regulation Q ceiling on interest diverted "national" U.S. business to London and helped establish the Euro-dollar market there.'

Regulation Q was a ceiling on interest rates that institutions could pay in the US to prevent a savings rate competition between commercial banks and other institutions entering the market, Stephen A Cowan, Susan E Foley, 'New Trends in Residential Mortgage Finance' (1978) 13 Real Prop. Prob. & Tr. J. 1075, 1077. In addition to the Interest Equalization Tax discussed in this Chapter, Regulation Q may have been one significant factor in driving business offshore from the US, but due to space limitations, it is not investigated further.

28 Edward J Kane, 'Accelerating Inflation, Technological Innovation, and the Decreasing Effectiveness of Banking Regulation' (1980) 36 The Journal of Finance 355, 358.

29 Jonathan R Macey, 'The Myth of "Reregulation": The Interest Group Dynamics of Regulatory Change in the Financial Services Industry' (1988) 45 Wash. & LeeL. Rev. 1275, 1277–82; Chapter 6.

observation was made in the same decade when there was 'undeniable movement towards greater international regulation of international business' and calls for the business communities themselves to take part in the design of the rules applicable to transnational corporations as their exclusion from the processes might lead to costly opposition by the same.[30] It is also acknowledged in this research that especially during the 1980s, 'efficient capital market hypothesis' was in vogue in economics and which was subsequently 'hijacked' by politicians in the 1980s for political purposes. [31] These are not central issues for the purposes of this research already because much of the transnationalisation processes precede this era.

This research could have been contextualized differently and filtered through a different kind of narrative that emphasises top-down policies for market liberalization by states. Instead of explaining transnational law through the evolution of transnational contracts, the starting point could have been state treaties under public interrnational law,[32] switch from the Bretton Woods system to the fractional reserve banking system in 1971,[33] or the introduction of international organizations such as the International Monetary Fund, or the establishment of Organization for Economic Cooperation and Development (OECD) and the agreements for the liberalization of capital movements.[34] Assumedly, they might have played a role in the transnationalisation of finance but the evidence put forward in this research suggests that much of the developments were uncoordinated and spontaneous driven by individual transactions carried out by a multitude of different creditors and debtors. However, transnationalisation processes might potentially be relabelled as an outcome of deliberate and externally controlled public policy driven by an underlying ideology and a political doctrine on markets and economy. This narrative is often coined under concepts like neoliberalism, market fundamentalism, or similar.[35]

30 Jonathan I Charney, 'Transnational Corporations and Developing Public International Law' (1983) Duke L.J. 748, 787.

31 Ronald J Gilson, Reinier Kraakman, 'Market Efficiency After the Financial Crisis: It's Still A Matter of Information Costs' (2014) 100 Va. L. Rev. 313, 315–16 < http://www.virginialawreview.org/sites/virginialawreview.org/files/Gilson%26Kraakman_Book%20final.pdf > visited 1 June 2019; for an earlier analysis, Jeffrey N Gordon, Lewis A Kornhauser, 'Efficient Markets, Costly Information, and Securities Research' (1985) 60 N.Y.U. L. Rev. 761.

32 Gohar G Stepanyan, 'Financial Liberalization and Foreign Institutional Investors: Literature review' in Narjee Boubakri, Jean-Claude Cossett (eds), *Global Capital Markets* (Emerald Group Publishing Limited 2011) 19–23.

33 For an overview, Eric Helleiner, 'Regulating the Regulators – The Emergence and Limits of the Transnational Financial Legal Order' in Terence C Halliday, Gregory Shaffer (eds), *Transnational Legal Orders* (CUP 2015).

34 OECD (2018), OECD Code of Liberalisation of Capital Movements, 4.

35 Ralf Michaels, 'On liberalism and legal pluralism' in Miguel Maduro, Kaarlo Tuori, Suvi Sankari (eds), *Transnational Law – Rethinking European Law and Legal Thinking* (CUP 2014) 122. Michaels views lex mercatoria and Islamic law as 'radical threats to the state', 139, and the former as a manifestation of 'neo-liberalism' which Michaels does not seek to define further than as a type of a liberalism 'that is not tied to the state but transcends it', 137; David Singh Grewal, Jedediah Purdy, 'Introduction: Law and

Fernanda D Nicola describes the rivalry being drawn between two groups in this area. Allegedly, there are '[n]eoliberal lawyers advocating for an efficient common market and greater regulatory competition and welfarist lawyers advocating for greater social justice and a European civil code for private law'. The reception of evidence is allegedly in both 'camps' calculating.[36] *Agustín José Menéndez* notes that '[w]hile it is hard to reconcile with neoliberal socio-economic theory, if such things exists, it provides a framework compatible with ordo-liberal, liberist, liberal, social-democrat, or Marxist accounts of the [financial and political] crises [of the European Union]'.[37] If neoliberalism and its variants is factually true, as a policy based on an identifiable ideology, or similar, which can be reconstructed as a framework, then it may offer a purposeful starting point for wildly differing critical, normative and prescriptive worldviews. However, the concept is problematic. As is argued in this Chapter 3, much of the transnationalisation of capital markets and the evolution towards the emergence and dominance of private regulatory mechanisms used today emerged and gained popularity among market participants during an era when the public policies of states were generally geared towards curbing international financial flows. In addition, this market evolution took place apparently during an era when something referred to as neoliberal paradigm was not, according to Menendez, apparently even close to being mainstream.[38]

Neoliberalism' (2014) 77 Law & Contemp. Probs. 1; Antonio Segura-Serrano, 'International economic law at a crossroads: global governance and normative coherence' (2014) 27 L.J.I.L. 677, 688, 692; Michael A Wilkinson, 'The Specter of Authoritarian Liberalism: Reflections on the Constitutional Crisis of the European Union' (2013) 14 German L.J. 527; Agustín José Menéndez, 'The Existential Crisis of the European Union' (2013) 14 German L.J. 453; Julia Black, 'Paradoxes and Failures: New Governance Techniques and the Financial Crisis' (2012) 75 Mod. L. Rev. 1037, 1061; Dan Awrey, 'Complexity, Innovation, and the Regulation of Modern Financial Markets' (2012) 2 Harv. Bus. L. Rev. 235, referring to an 'influence of market fundamentalist thinking on the established wisdom underpinning the Post-war push to liberalize international trade and capital flows' n 7; Timothy A Canova, 'Banking and Financial Reform at the Crossroads of the Neoliberal Contagion' (1999) 14(6) American University International Law Review 1572.

36 Fernanda F Nicola, 'Transatlanticisms: constitutional asymmetry and selective reception of U.S. law and economics in the formation of European private law' (2008) 16 Cardozo J. Int'l & Comp. L. 87.

37 Menéndez (n 35) 465; Financial *laissez faire* is about the idea of free banking, i.e. the absence of government intervention into the financial sector including central banks, government-sponsored deposit insurances and government regulations on the financial system more generally. Kevin Dowd 'Free Banking' in Peter J Boettke and Christopher J Coyne, *The Oxford Handbook of Austrian Economics* (OUP 2015) 213; Kevin Dowd, 'The Case for Financial Laissez-Faire' (May, 1996) 106 (436) The Economic Journal, 679; Financial laissez faire in this meaning never existed during the timeframe of this reserch. For a historical case study, Tyler Beck Goodspeed, *Legislating Instability: Adam Smith, Free Banking, and the Financial Crisis of 1772* (Harvard University Press 2016).

38 Menéndez (n 33) 476 'The neoliberal paradigm became part of the mainstream, emerging from the radical wilderness to which it was confined in the 1950's and 1960's.' Similarly, Rajesh Venugopal, 'Neoliberalism as concept' (2015) 44 (2) Economy and Society 165, 168:

> Before 1980, neoliberalism was an esoteric term, used scarcely, and then only by economists. Since then, it has become one of the most widely used terms across many social science disciplines, except in economics where it has disappeared.

Oliver Marc Hartwich notes that:

> If neoliberalism is hardly ever defined, if it can mean anything you wish to disagree with, then it is understandable that it results not from an attempt to gain theoretical knowledge but from the desire to defame your political opponents. In this way, the neoliberal label has become part of political rhetoric, albeit as an almost meaningless insult.[39]

Echoing the argument of Hartwich, in his critique of the neoliberal narrative, *Rajesh Venugopal* acknowledges a fundamental problem in one of the central literature sources on the topic. It does not include a single source for what it considers a neoliberal theory.[40] As further summarized by Venugopal, the problem is that the concept of neoliberalism, or its variant 'ordoliberalism', was from the beginning used by its proponents in '[e]ntirely contradictory and opposite ways'. The concept creates 'analytical blind spots by conflating significantly different phenomena under a common term'. While not being necessarily useful for academic purposes, the use of 'neoliberalism' creates an unintended side-product that might be useful for an observer. It may tell an observer how 'critical scholarship' built on '[m]orally loaded, one-sided deployment of neoliberalism' is constructed.[41] For the purposes of this research, neither governance theories nor narratives are not that relevant as its primary purpose is to gather legal theoretical knowledge by applying transnational method to what is refers to as transnational law. What is needed to understand at this point is that transnationalisation does not require nor is dependenant on formal acts of deregulation by states nor political decisions of their electorates to liberalize capital movements as tempting it might be to think that it does. The evidence would more suggest that states sough to further 'liberalize' capital movements only once it was understood that investors had already liberated themselves.

3.3 THE KNOWN UNKNOWNS: THE ONTOLOGY OF TRANSNATIONAL CORPORATIONS

3.3.1 TRANSNATIONAL CORPORATIONS

Transnational method is first and foremost about acknowledging, identifying and studying private normativity and bottom-up law-making processes and their interactions with states. Transnational law is about conceptualizing a legal

39 Oliver Marc Hartwich, 'Neoliberalism: The Genesis of a Political Swearword' (2009) CIS Occassional Paper 114, 2 <https://www.cis.org.au/app/uploads/2015/07/op114.pdf> accessed 1 June 2019.

40 Venugopal (n 38) 183.

41 Venugopal (n 38) 183.

phenomenon that does not fit well into existing categories of law. To illustrate this point, the concept of 'transnational corporation' is revisited. Transnational or multinational corporations have been researched at least since the 1950s. They were referred to being transnational in their ontology since they did not fit into existing categories of law. The terms are sometimes confusing and 'always imprecise' but transnational corporations have generally been understood in a more or less same manner as a cluster of corporations of diverse nationality with common ownership and a common management strategy.[42] One of the modern notions of transnational law can be traced back to at least 1963, when *Clive Schmitthoff* envisioned a law of international trade, that would be autonomous by its nature and that would constitute a common platform for commercial lawyers regardless of their background, legal education, and the governance structure of their home states.[43] The observation of the United Nations Centre on Transnational Corporations in 1985 is as relevant as ever since in light of the evidence put forward in this subchapter, it is true:

> [A] number of factors [...] conspire to make purely national control systems variously evadable, inefficient, incomplete, unenforceable, exploitable, or negotiable [...] with respect to transnational corporations.[44]

Without seeking to mysticize transnational corporations, much about their ontology still remains unknown. Historically, transnational corporations were regulated from the outset in terms of export controls, securities regulation, antitrust law, and taxation but they could also operate in unregulated areas.[45] As noted by *Patrice-Hubert Petit* and *David Chekroun*, transnational company groups have a 'strong national root due to the parent company's geographical establishment' while the majority of their turnover is 'dispersed across the world'. More currently, these groups operate in an increasingly complex legal and regulatory environment. Yet it is still difficult to identify such 'groups' and their transnational elements from a state law perspective. For example, national legal orders tend to identify the single individual legal entities within a group but not the group as a whole. In such an environment, transnational groups tend to self-regulate their behaviour

42 Raymond Vernon, 'Economic Sovereignty at Bay' (1968) Foreign Affairs 110, 114; Robert B von Mehren, Martin E Gold, 'Multinational Corporations: Conflicts and Controls' (1976) 11 Stan. J. Int'l Stud. 1.

43 Clive M Schmitthoff, 'The Law of International Trade, Its Growth, Formulation and Operation' in Chia-Jui Cheng (ed), *Clive M. Schmitthoff's Select Essays on International Trade Law* (Kluwer Academic Publishers 1988) 139.

44 UN Centre on Transnational Corporations: Environmental Aspects of the Activities of Transnational Corporations: A Survey (1985) para 51, quoted in Fleur Johns, 'The Invisibility of the Transnational Corporation: An Analysis of International Law and Legal Theory' (1994) 19 Melb. U. L. Rev. 893, 896.

45 Mehren, Gold (n 42) 10.

through their own governance structures.[46] This is why the term 'transnational' as a conceptualization of private normativity is as relevant as ever.

The 'exponential growth' of transnational corporations was seen as a challenge for the legal profession and scholarship from the outset.[47] Generally, the intercorporate holdings of parent companies in foreign subsidiaries were often subject to local legal restrictions de jure but the impact of such restrictions were more that of a hindrance than an insurmountable obstacle for transnational corporations.[48] Transnational corporations do typically have an identifiable jurisdiction where their headquarters are located: a local company register will tell an outside observer that much. Who actually owns transnational corporations? Transnational corporations can choose the venues where they raise their capital or in which exchanges their equity and other securities are traded and are in this respect autonomous from their stated home jurisdiction.[49]

By using derivatives structures, the real share ownership in public companies can be hidden with relative ease. The development towards this possibility was noted as early as 1987 by the likes of *Mark D Young* and *William L Stein*, who noted how '[n]othing precludes the financial wizards from one day conjuring up stock-index swaps. If successful, the international and national equity securities markets would then be linked to self-regulated swap markets'.[50] In principle, swaps can be used to replicate virtually any kind of financial transaction as demonstrated in detail in Chapter 5. According to one source, equity swaps that can be structured as stock-index swaps were introduced to the financial markets in 1989.[51] Local withholding taxes imposed on dividends paid to foreign investors by local companies lose meaning. Foreign investors can reach the same economic position, without being subject to the withholding tax, by investing in stock-index swaps emulating the aforementioned local share-index in every economic detail.[52] Combined with

46 Patrice-Hubert Petit, David Chekroun, 'Governance of transnational groups: what are the stakes? What are the challenges?' (2016) 6 I.B.L.J. 617, 618, 625–26, 631–33; Peter Hansen, Victoria Aranda, 'An Emerging International Framework for Transnational Corporations' (1990) 14 Fordham International Law Journal 881, 882:

> [t]he nature of the transnational corporation as a group of enterprises with a unified structure and with common control and strategy has yet to find a legal regime that matches those characteristics. From the legal perspective, a transnational corporation is only recognized as a group of separate national companies established under the laws of different countries.

47 Detlev F Vagts, 'The Multinational Enterprise: A New Challenge for Transnational Law' (1969–1970) 83 Harv. L. Rev. 739. Vagts notes that 'the multinational enterprise' is 'certainly post-World War II and largely post-1955' creation, 746.

48 ibid 742–43.

49 AC Pritchard, 'London as Delaware?' (2009) 78 Univ of Cincinnati Law Review 473, 474.

50 Mark D Young, William L Stein, 'Swap Transactions under the Commodity Exchange Act: Is Congressional Action Needed' (1988) 76 Geo. L. J. 1917, 1942.

51 Drew E Macintyre, 'Financial innovation and regulatory trepidation: swaps and the OSC' (1995) 25 CBLJ 163, 165.

52 David P Hariton, 'Equity Derivatives, Inbound Capital and Outbound Withholding Tax' (2007) 60 Tax Law. 313, 318.

an option structure that allows the stock-index swap holder to acquire the actual shares, market participants are able to launch takeover campaigns on corporations in secret. [53]

Recent scholarship notes that derivatives can be used to subvert insider trading and anti-market manipulation laws. As *Yesha Yadav* summarizes the market, '[e] ither this [credit derivative] thriving market is operating outside or at the margins of existing law-or the law itself has not adapted to the existence of these markets.[54] Credit derivative markets emerged in the mid-1990s in cooperation with a state financial institution, transnational financial institution, and a transnational corporation. In time, market participants developed their own private regulatory mechanisms based on the ISDA MA architecture for this market as further discussed in subchapter 5.10. Transnationally operating corporations can, as a technical matter, render local disclosure regulations meaningless with relative ease by using cash-settled options. The transnational setting leaves much room for financial innovation.[55] Contemporary financial regulation in the EU require the holder of such hidden positions to notify these positions to regulators who disclose these positions to the public. In the EU, this requirement was introduced in the Second Transparency Directive in 2013[56] and the notification requirements were nationally transposed to the legal systems of the Member States in 2015. This took place over 30 years after the rapid expansion in the OTC derivatives market. Recital 9 of the Second Transparency Directive notes the same thing addressed in this subchapter:

> Financial innovation has led to the creation of new types of financial instruments that give investors economic exposure to companies [...] Those instruments could be used to secretly acquire stocks in companies, which could result in market abuse and give a false and misleading picture of economic ownership of publicly listed companies [...] the definition of financial instruments [...] should cover all instruments with similar economic effect to holding shares and entitlements to acquire shares.[57]

53 Elina Khasina, 'Disclosure of Beneficial Ownership of Synthetic Positions in Takeover Campaign' (2009) Colum. Bus. L. Rev. 904.

54 Yesha Yadav, 'Insider Trading in Derivatives Markets' (2014–2015) 103 Geo. L.J. 381, 386.

55 Armin J Kammel, 'The dilemma of blind spots in capital markets – how to make efficient use of regulatory loopholes?' (2009) 10 German L.J. 605

56 Article 13 of Directive 2013/50/EU of the European Parliament and of the Council of 22 October 2013, OJ L 294, 6.11.2013, p. 13–27.

57 ibid Recital (9).

Transnational corporations also benefit from wider array of choices and legal arbitrage in the *transnational law market*[58] where 'the specific cost-benefit position of TNCs [transnational corporations] translates into superior choice incentives' in comparison to small or medium-size enterprises. The benefits range from scale economies of being able to use standardized contracts in different business areas perhaps globally to the ability to choose which bankruptcy regime applies to their operations.[59]

Perhaps unexpectedly, in the OTC derivatives market, there has traditionally not been that much reason to engage in 'forum shopping', the one use of which is to strategically have a case heard in the most favourable court to the party or the parties, and not necessarily in the most appropriate court from a legal point of view. As the evidence put forward in Chapter 5 suggests, the vast majority of all OTC derivatives transactions executed under the ISDA MA architecture were from its beginning and for the time period relevant for this research, the 1980s to early 2010, governed by default either English law or the laws of the state of New York and the jurisdiction English courts or the courts of the state of New York, respectively. The popularity of English law may have changed in the post-global financial crisis (GFC) world. For example, large market participants in the US started increasingly to negotiate for the inclusion of pre-dispute arbitration clauses to their derivative agreements with end-users out of the fear of class-action law suits which can be very costly and, in any case, public.[60] In 2013, ISDA released the ISDA Arbitration Guide,[61] and in 2018, the ISDA Choice of Court and Governing Law Guide at the request of its members. The 2013 Guide includes model arbitration clauses as well as model jurisdiction clauses that can be included to the standard ISDA MA architecture.[62] One reason is that market participants from emerging markets may find arbitration awards more easily enforceable than the rulings of New York and English courts.[63] Historically, at least in the US, market participants have favored arbitration if market participants deem state intervention too intrusive or public courts unresponsive for commercial needs.[64]

58 Horst Eidenmüller, 'The Transnational Law Market, Regulatory Competition, and Transnational Corporations' (2011) 18 Ind. J. Global Legal Stud. 707, 711, 730.

59 ibid 727–29.

60 Zachary E Davison, 'Minding the Gap: A Call for Standardizing Pre-dispute Arbitration Clauses in OTC Derivative Transactions' (2014–2015) 59 N.Y. L. Sch. L. Rev. 707.

61 ISDA, '2013 ISDA Arbitration Guide' <https://www.isda.org/a/6JDDE/ISDA–arbitration–guide–final–09–09–13.pdf> accessed 1 June 2019.

62 2018 ISDA Choice of Court and Governing Law Guide.

63 Peter Cresswell, Stuard Dutson, Connor Redmond, 'Towards an expedited and cost-effective arbitration award in financial services disputes' (2016) 82 Arbitration 306, 307.

64 Bruce L Benson, 'The Spontaneous Evolution of Commercial Law' (1989) 55 Southern Economic Journal 644, 656.

Often the distancing and denationalizing of transactions from any particular legal system of a state has been the very objective of not only by the private parties engaging in what can be referred to as regulatory arbitrage (discussed in subchapter 3.5.3) which is a public policy problem to some to be tackled by states and to others a part of the ontology and inherent and inseparable dynamics of transnational finance, but also public officials and regulators themselves. This development led legal researchers in the 1950s and 1960s to ask whether this development would bring to existence a *non-national autonomous private entity* (i) that does not have a de facto specific country of incorporation, (ii) that has a widely dispersed business activity and shareholding, and (iii) that has an internationalized management,[65] the members of which take its decisions in light of international economic factors affecting the non-national autonomous private entity rather than the national welfare as conceived by nation states.[66]

Far from being unaware of the tension between public versus rising private power, there were early calls for international cooperation, the purpose of which was clear, 'to enable world-minded corporations to serve the world's interest as properly regulated citizens of the world'.[67] The status of transnational corporations led to observations such as that '[t]he law, national and international, is completely out of date so far as transnational corporations are concerned' and that economic facts over their ontology were being rushed at the cost of proper legal and political theory.[68] *Robert Gilpin* summarized the situations as follows:

> [O]n the one hand, powerful economic and technical forces are creating a highly integrated transnational economy, blurring the traditional significance of national boundaries. On the other hand, the nation

65 It might be useful to also turn to early findings made in management research in which the demand for 'international general managers' was identified, Lawrence E Fouraker, John M Stopford, 'Organizational Structure and the Multinational Strategy' (1968) 13 Administrative Science Quarterly 47, 53–54.

66 Vagts (n 47) 789, noting also that certain off-shore jurisdictions enable the use of de jure place of incorporation and a de facto 'declaration of independence from all significant relationships to a home country' as well as that '[M]NE's [multinational enterprise] at some point might decide that the legal and political burdens of their United States connection were no longer worthwhile', 787. For tax structuring techniques employed by US firms already during the 1960s, Robert J McDonald, 'Section 367–A Modern Day Janus' (1964) 64 Colum. L. Rev. 1012.

67 Anthony M Solomon, 'Foreign Investment Controls: Policy and Response' (1969) 34 Law & Contemp. Probs. 118, noting '[s]ome 300 or 500 major international corporations will own seventy-five per cent of the fixed industrial assets outside the public sector in the non-communist world', 125. The concentration of market activity to relatively few transnational financial institutions, the implicit antitrust concerns, and the increasingly complex regulatory framework was also acknowledged during that era, Benjamin J Klebaner, 'Conglomerate Commercial Banking: Issues and Policies' (1970) 44 St. John's L. Rev. 499, 501–9.

68 Arthur S Miller, 'The Corporation as a Private Government in the World Community' (1960) 46 Va. L. Rev. 1539, 1571, n 7.

> state continues to command men's loyalties and to be the basic unit of political decision.[69]

This has always been true in financial regulation: finance operates transnationally, and public regulations more locally, even where there is transgovernmental cooperation and there is loyalty to the nation state, even among financial regulators that in principle are there to combat risks that transcend national borders.[70] Hence the concept of transnational law that conceptualizes the phenomena of private normativity that demonstrably transcend the borders of nation states and that includes elements that are hard to quantify or even to identify under traditional and established areas of law. In the 1990s, 'transnational cooperation' was to be understood as the cooperation between governmental agencies and transnational actors, that is, private market participants and their respective private trade organizations. OTC derivatives master agreements can be seen as the outcome of transnational cooperation.[71] In 2015, scholars viewed ISDA as 'the principal transnational trade association and standard-setter for the OTC derivatives markets'.[72]

The risks and tensions that foreign direct investment of transnational corporations might pose to state sovereignty have been long acknowledged and analyzed.[73] Policy makers sought to intentionally create modern lex mercatoria to facilitate and unify international trade laws. This work was carried out especially under the United Nations Commission on International Trade Law (UNCITRAL) and The International Institute for the Unification of Private Law (UNIDROIT). These efforts took inspiration and drew parallels, perhaps hastily so, from historical lex mercatoria. From this perspective, national interference was seen as problematic for both international trade as well as the economic wellbeing of developing nations

69 Robert Gilpin, 'The Politics of Transnational Economic Relations' (1971) 25 International Organization 398; Chapter 7, n 137.

70 Chris Brummer, 'Does today's world need a global financial regulator?' (2014–2015) 33 Int'l Fin. L. Rev. 18, 19, arguing that a political objective of establishing a global financial regulator is problematic given that nation states are unlikely to give up on their sovereignty. For an argument in favour of a global financial regulator, Tajinder Singh, 'Does today's world need a global financial regulator?' (2014–2015) 33 Int'l Fin. L. Rev. 18. According to Singh:

> [m]ove to an enforceable system, whether treaty based or otherwise, will certainly not happen overnight. But now is the time to start thinking on this, and for wise persons to put their heads together; Chapter 6 (n 135); Subchapters 6.4 and 6.7.5.

71 Thomas C Singher, 'Regulating Derivatives: Does Transnational Regulatory Cooperation Offer a Viable Alternative to Congressional Action' (1995) 18 Fordham Int'l L.J. 1397.

72 John Biggins, Colin Scott, 'Public-private relations in a transnational private regulatory regime: ISDA, the state and OTC derivatives market reform' (2012) 13 EBOR 309 (2015) 378.

73 Vernon (n 42) 116–17; Raymond Vernon 'Sovereignty at Bay Ten Years After' (1981) 35 International Organisation, 517, noting how 'the advocates and the opponents of multinational enterprises were already locked in furious combat' by 1971. One might ask how much effect, if any, such discourse had on the transnationalisation of finance.

to which foreign direct investment was directed in exceeding numbers.[74] For example, the home state of a transnational corporation might exercise its powers through the parent company, which in turn has a foreign subsidiary, making the transnational corporation potentially an effective vehicle to enforce policies over foreign states. In turn, from the investor perspective, the host state might exercise its direct powers on the foreign subsidiary[75] or seek other retaliatory measures against such influences.[76] From the host state perspective, the direct investments of transnational corporations could be viewed as an unwelcomed cultural expansion by foreign powers, especially those of the US.[77] The ability of investors to avoid the applicability of the laws and regulations of the US was seen as a by-product of internationalization of transnational corporations.[78]

3.3.2 LEGAL THEORETICAL CONTRIBUTION OF TRANSNATIONAL LAW

As demonstrated in the preceding subchapter, transnational law is much about research on private normativity. The ontology of transnational corporations has been raised in earlier legal scholarship: it has been studied extensively under the rubric of transnational law and many legal scholars have characterized the ontology of the market in which transnational corporations operate as something that has 'less and less significant identity with any single nation or government'.[79] Transnational method helps to identify and name private normativity that transcends the boundaries of states and existing categorizations of law.

Detlev Vagts already discussed the legal nature of transnational corporations in 1960s private corporations that transcended the boundaries of states on many levels and 'which must content itself with string together corporations created by the

74 Louise Hertwig Hayes, 'A Modern lex mercatoria: political rhetoric or substantive progress?' (1976–1977) 3 Brook. J. Int'l L. 210.

75 For earlier discussion on investment treaty arbitration, J Gillis Wetter, 'Salient Clauses in International Investment Contracts' (1962) 17 Bus. Law. 967, noting also that concession agreements under which private corporations 'obtained a more or less quasi-governmental status' can be traced at least back to the 18th century, 967–68.

76 Eckard Rehbinder, 'The Foreign Direct Investment Regulations: A European Legal Point of View' (1969) 34 Law & Contemp. Probs. 95, 97–98. Often such tensions involve energy sector, geopolitics, and technology transfers. For a cold-war era example, Patrizio Merciai, 'The Euro-Siberian gas pipeline dispute – a compelling case for the adoption of jurisdictional codes of conduct' (1984) 8 Md. J. Int'l L. & Trade 1, 28:

> Present international law does not confer a single personality on the many legal persons, each incorporated under the laws of the different State, that together make up the single economic entity known as a multinational enterprise.

77 Solomon (n 67) 121–22.

78 Solomon (n 67) 118, 124.

79 Mehren, Gold (n 42) 1, 3.

laws of different states' in comparison to intergovernmental organizations.[80] During the same era, it was already clear that transnational corporations would be subject to conflicting national jurisdictions and that some of these corporations would be able to evade the jurisdiction of any state at least to some extent. Problematic phenomena from the state perspective were seen as 'by-products of increasing internationalization of American business'.[81] Further, many others have continued from these and similar findings by putting forward observations and questions about, for example, the nature of mercantile law as a body of customary law 'which is the foundation on which national and international commercial legislation has been and continues to be built'.[82] The critical role of a transnational corporation in wealth creation, and tax revenues needed to run a state, has been long acknowledged as has been the calls for their regulation.

3.3.3 OBSERVATIONS FROM TRANSNATIONAL ARBITRATION

Transnational lex mercatoria has been a highly polarizing concept amongst academics and legal practitioners for a long time.[83] Transnational lex mercatoria has been construed to operate as a part of customary economic rules, a subset of public international law.[84] There is agreement among scholars that it is legitimate to refer to transnational commercial law that includes private normativity as one source of legal norms. Again, private normativity cannot displace national laws or public policies through contractual means. Nevertheless, transnational law is about legal norms that can derive from other sources than states. Such norms can be contract-based, and these transnational contracts form the transnational lex mercatoria of finance as is described in Chapter 5. As pointed out by *Roy Goode* on transnational law, the non-autonomity of international commercial practice, and the still ill-defined and not readily ascertainable concept of the new *lex mercatoria*, it is:

> [A] set of legal norms not based on any one legal system but derived from variety of sources, some of which [...] may not be legal instruments but may nevertheless be resorted to as evidence of a consensus on appropriate legal rule towards which arbitrators can be more responsive

80 Vagts (n 47) 740.

81 Solomon (n 67) 124–25.

82 Harold J Berman, Colin Kaufman, 'The Law of International Commercial Transactions (Lex Mercatoria)' (1978) 19 Harv. Int'l. L. J. 221, 223.

83 Emmanuel Gaillard, 'Thirty Years of Lex Mercatoria: Towards the Selective Application of Transnational Rules' (1995) 10 ICSID Review, 208, 209.

84 For earlier discussion, Stephen Zamora, 'Is There Customary International Economic Law?' (1989) 32 German Y.B. Int'l L. 9, 15, 23.

> than national courts, and which can supplement but which cannot displace a national legal system determined under conflict of laws rules.[85]

The existence of something referred to as a modern lex mercatoria has not gone unnoticed in the EU either.[86] Empirical evidence suggests that the application of transnational law or modern lex mercatoria as an explicitly stated governing law of contracts is rare.[87] *Gilles Cuniberti* acknowledges the limitations of conducting an empirical study regarding the use of transnational law or similar as the governing law of contracts. The empirical evidence available suggests that commercial parties rarely choose lex mercatoria, transnational law, or similar, as the governing law of their contracts.[88] Such evidence has been often seen as a reason to bypass arguments in favour of the existence of transnational lex mercatoria or at the very least dispute its autonomous nature.[89] Autonomous does not equate independence from surrounding societies in which autonomous action of private individuals takes place.[90] One reason behind the seeming ‘gridlock’ in the autonomy of transnational law is that many understand what is meant by ‘autonomous’ differently and then use it in vastly different contexts. However, what can be agreed is that ‘[a]utonomy implies something that is outside the realm of the State’.[91] In narrow sense, the autonomy can be understood to refer to freedom of contract and in a wider sense to the systemic autonomy of lex mercatoria itself. Some emphasize that norms arise spontaneously from business communities and some emphasize legal positivism and its exclusivity aspect and view the phenomena as ultimately a question of private international law. For some, the conceptualization of transnational law is

85 Roy Goode, Herbert Kronke, Ewan McKendrick, *Transnational Commercial Law, Texts, Cases and Materials* (2nd edition, OUP 2015) 31.

86 Green Paper on the conversion of the Rome Convention of 1980 on the law applicable to contractual obligations into a Community instrument and its modernization. COM (2002) 654 final, 22, ‘It is common practice in international trade for the parties to refer not to the law of one or other state but [...] to the lex mercatoria’.

87 Christopher R Drahozal, ‘Contracting out of national law: an empirical look at the new law merchant’ (2004–2005) 80 Notre Dame L. Rev. 523, concludes that the use of transnational law in international arbitration has at least served as a marketing tool for some arbitrators if nothing else, 549–51, and draws the conclusion partially from empirical evidence that demonstrates that corporate actors seldom use lex mercatoria and partially on the basis of a sociological argument put forth in Yves Dezalay, Bryant G Garth, *Dealing in Virtue, International Commercial Arbitration and the Construction of a Transnational Legal Order* (University of Chicago Press, 1996) 88–91; similarly to Drahozal, Celia Wasserstein Fassberg, ‘Lex Mercatoria - Hoist with Its Own Petard’ (2004) 5 Chi. J. Int’l L. 67, 82.

88 Gilles Cuniberti, ‘Three Theories of Lex Mercatoria’ (2013) 52 (1) Colum. J. Transnat’l L. 369, also discussing how ISDA MA is not autonomous from national legal orders given the fact that it is governed by state laws and because of its inevitable connection to public policies of states, 376–77.

89 Terence C Halliday, Gregory Schaffer, ‘Introduction – Transnational legal orders’ in Halliday, Shaffer (n 33) 3, n 8.

90 Bernardo M Cremades, Steven L Plehn, ‘The new lex mercatoria and the harmonization of the laws of international commercial transactions’ (1983–1984) 2 B.U. Int’l L. J. 317, 329–31.

91 Helen E Hartnell, “Living La Vida Lex Mercatoria’ (2007) 12 Unif. L. Rev. n.s. 733, 735.

an ideological battleground at the expense of ‘scientific, inquiring spirit’.[92] Perhaps with the exception of the last group, the differing views between legal positivism and transnational legal theory can find a common ground, and for those troubled by the idea of finance somehow escaping the state, it may be of comfort to hear that virtually every aspect of trade in over-the-counter derivatives and the terms and conditions contained in the master agreement architecture has become publicly regulated in the aftermath of the global financial crisis as discussed in Chapter 6.

To briefly summarize the findings of *Emmanuel Gaillard*, contemporary legal theoretical considerations on international arbitration tells that the legitimacy of international arbitration is recognized by nation states. National legal orders can accept the idea of an arbitral legal order founded on public international law. One can reach this conclusion from both natural law and positive law premises. ‘Transnational’ does not mean ‘a-national’ or stateless law. However, drawing a theoretical construct is difficult as it becomes increasingly more complex the more one seeks to characterize these private transnational rules as an arbitral legal order. In other words, it is one thing to accept that transnational rules are applied in arbitral proceedings and another whether to accept an existence of a true arbitral legal order based on such transnational rules.[93]

Transnational corporations themselves seem persistently to disagree with the suitability of lex mercatoria to govern their contractual relations. Its use as the explicit governing law of contracts is rare, but still a reality.[94] Arbitral awards based on lex mercatoria are generally enforceable in national courts and its use may carry many benefits for the contracting parties.[95] In a survey conducted in 2008[96] found that ‘general principles of international commercial contracts’, ‘the lex mercatoria’ or the like are used as the governing law of contract ‘often’ by 6 per cent and ‘occasionally’ by 13 per cent of the respondents, while 23 per cent responded ‘almost never’ and 58 per cent ‘never’.[97] Importantly, this tells us little about the prevalence of transnational lex mercatoria. The governing law of contracts can be construed by using other phrases. Arbitral awards, for example, may refer to regimes, including equity, common law, or trade practices, custom, or usage of trade,[98] and arbitral tribunals generally apply a particular component or ‘branch’ of

92 ibid 736, 747, n 50.

93 Emmanuel Gaillard, *Legal theory of international arbitration* (Martinus Nijhoff Publishers 2010) 35–61.

94 Drahozal (n 87) n 39, 537–40, 543–44.

95 Markus Petsche, ‘The Application of Transnational Law (Lex Mercatoria) by Domestic Courts’ (2014) 10 JPIL, 489, 503–08.

96 The Oxford Institute of European and Comparative Law and the Oxford Centre for Socio-Legal Studies, ‘Civil Justice Systems in Europe: Implications for Choice of Forum and Choice of Contract Law – A Business Survey’ <https://www.fondation-droitcontinental.org/fr/wp-content/uploads/2013/12/oxford_civil_justice_survey_-_summary_of_results_final.pdf > accessed 1 June 2019.

97 ibid Question 23.

98 Leila Anglade, ‘The use of transnational rules of law in international arbitration’ (2003) 38 Irish Jurist 9.

transnational law and determine the contents of transnational law on a case-by-case basis.[99] Against this background, the aforementioned figure could be 100 per cent for 'never' and yet there would be perfectly room for transnational lex mercatoria under trade practices, custom, or usage of trade, and similar. As discussed, some of the transnational sources are not necessarily legal instruments provided by states, yet they can be said to be legal norms that can be drawn from a variety of sources, including those of private origin.[100] Legal theoretical considerations aside, this is how transnational financial contracts and state laws can interact in court praxis as demonstrated in subchapter 5.2.5.

Going back to arbitration, the ruling in *International Court of Justice Barcelona Traction Belgium v. Spain*[101] might serve not only as an illustrating period piece on the evolution of transnational corporations but also as an observation on the spontaneous and evolutionary aspects of transnational law based on a contract:

> Considering the important developments of the last half-century, the growth of foreign investments and the expansion of the international activities of corporations, in particular of holding companies, which are often multinational, and considering the way in which the economic interests of States have proliferated, it may at first sight appear surprising that the evolution of law has not gone further and that no generally accepted rules in the matter have crystallized on the international plane. [...] [...] *a body of rules could only have developed with the consent of those concerned.* [102]

One traditional driver for the transnationalisation of arbitration was states themselves, or more accurately, the legal and political risk arising from states. These conflicts, in turn, tied transnational corporations to international law firms operating under and construing the arbitral awards under the auspices of public international law[103] and specifically under the International Chamber of Commerce.[104] Going back in history, the risk of nationalization of foreign assets materialized often especially in the petroleum industry in the Middle-East during the 1950s and 1960s. These risks gave the parties concerned, transnational corporations and third-

99 Petsche (n 95) 500, 509.

100 Goode and others (n 85).

101 Barcelona Traction, Light and Power Co., 1970 I.C.J. 3.

102 ibid 89, discussed in Merciai (n 76) 28–31.

103 Mehren, Gold (n 42) 8–10.

104 Thomas J Biersteker, 'The Illusion of State Power: Transnational Corporations and the Neutralization of Host-Country Legislation' (1980) 3 Journal of Peace Research 207, summarizing some of the techniques employed by transnational corporations as to ensure 'a minimal loss of control over their operations' 214, 215–19.

world countries both represented often by Anglo-American law firms, an incentive to seek a neutral jurisdiction for the arbitration process which was often found among European countries.[105] Allegedly, transnational corporations did not receive adequate compensation for the expropriation or other interference on their assets by states.[106] It was already during these times, and partially through high-profile arbitral awards, when talks about the emerging 'New International Legal Order' entered the scholarly discussion and government policies. For example, claims were made that state sovereignty is relative rather than absolute when it comes to the natural resources located in their respective territories.[107]

Arbitral awards of those times have been referred to as the 'founding acts' of a *transnational legal order*, which in turn was created 'merely by accident and without self-awareness', echoing a degree of spontaneity as to its emergence, and how the legitimacy of the transnational legal order 'rests on the way representation is structured' on both sides of the conflict - often for the benefit of especially Anglo-American intermediaries.[108] As it was then, it is still common for contracting parties to 'contract-out' from countries with less developed legal infrastructure by using international arbitration instead of local courts and local laws.[109]

The outflow of capital from oil-exporting states is also and at least indirectly connected to the issue of eurobonds and the rapid emergence of the eurodollar market,[110] and directly connected to: the proliferation of bank lending in the 1970s when sovereigns became the borrowers and oil-exporting states their creditors via commercial banks;[111] the so-called 'petrodollars' and the Organization of the Petroleum Exporting Countries in general;[112] the early notion of how 'an integrated worldwide capital market exists today beyond the control of any one nation or monetary authority' the regulation of which would to some extent require 'some sacrifice of national sovereignty';[113] the impact of petrodollars on the demand for

105 Dezalay, Garth (n 87) 63–69.

106 Samuel KB Ansante, 'International law and foreign investment: a reappraisal' (1988) 37 Int'l & Comp. L.Q. 588, 604–09; Richard Hay, 'Protecting assets from political risk' (1997) 3 P.C.B. 1997, 152, 153.

107 K Venkata Raman, 'Transnational corporations, international law, and the new international economic order' (1978–1979) 6 Syracuse J. Int'l L. & Com. 17.

108 Dezalay, Garth (n 87) 65–75.

109 Eidenmüller (n 58) 732.

110 Stuart R Singer, 'Current Problems of Structuring Petrodollar Loans' (1976) 27 Mercer L. Rev. 469; Corinne R Rutzke, 'The Libyan Asset Freeze and Its Application to Foreign Government Deposits in Overseas Branches of United States Banks: Libyan Arab Foreign Bank v. Bankers Trust Co' (1988) 3 Am.U.Int'l L.Rev. 241, 254.

111 Lee C Bucheit, 'A Lawyer's Perspective on the New International Financial Architecture' (1999) 14(7) J.I.B.L. 225; RM Auerback, 'Sovereign debt – default and restructuring of debts owed to private creditors' (2003) 18(11) J.I.B.L.R. 440.

112 Walter J Levy, 'The Years That the Locust Hath Eaten: Oil Policy and OPEC Development Prospects' (1978) 57 Foreign Aff. 287.

113 Jahangir Amuzegar, 'OPEC and the Dollar Dilemma', (1978) 56 Foreign Aff. 740, 747–50, discussing how the eurodollars are outside the reach of the US and the futility of attempting to control this through currency and capital controls and the overall limited policy choices the US had at its disposal at that time.

new financial regulation already in the 1970s,[114] and for the development of the European integration and the problem of the member states of the EEC in dealing with difficulties in balance of payments.[115] These developments are not central for the description of the transnationalisation processes of finance, explained through the evolution of transnational contracts, which is why they are only mentioned here.

3.4 THE EUROBOND MARKET REVISITED: THE EMERGENCE OF TRANSNATIONAL CUSTOMARY LAW

3.4.1 INTRODUCTION

The history of the eurobond market is also the history of the OTC derivatives market and without knowing the former, it may be difficult to form a transnational view of the latter. As described by *Peter Gallant*, 'The Eurobond markets have no home'. The term 'eurobond' is jargon originating from the 1960s which refers to debt securities that are not domestic in their nature as they are not sold in the home currency of the borrower or the borrower's home market. Nor are they foreign debt securities, as they are not intended to be sold to investors in the place where they are issued. The eurobond market grew rapidly in the 1980s and one of the main reasons for this was that eurobonds combined with swaps, a common type of OTC derivative discussed in Chapter 5, allowed market participants to avoid local exchange controls.[116] The precise meaning of eurobond is somewhat context bound.[117] Eurobonds were from the beginning used as a means of finance by private borrowers and public actors from governments to international financial organizations.[118] The idea of syndicated underwriting bond arrangements dates back to at least the end of 19th century and as such, the eurobond market was not a new phenomenon; Neither are capital flows from one jurisdiction to another.[119]

As an introduction, it is useful to briefly summarise the idea and process of a bond issue. Bond issues are a central type of transaction that can take place in international capital markets to raise funds from the market for both states and

114 Mehren, Gold (n 42) 1, 5.

115 Peter Herzog, 'The European Community and the Recycling of Petrodollars' (1975) 3 Syracuse J. Int'l L. & Com. 425.

116 Peter Gallant, *The Eurobond Market* (Woodhead-Faulkner 1988) 7–9, 144–45. Later on, eurobond issues were to be referred to as 'international bonds' or simply 'bond issues', to avoid confusion with the euro as a separate currency, Geoff Fuller, 'Bond Issues' in Sarah Paterson, Rafal Zakrzewski (eds), *McKnight, Paterson and Zakrzewski on the Law of International Finance* (2nd edition, OUP 2017) 536.

117 Dalhuisen (n 20) 662.

118 Georges R Delaume, 'Choice of Law and Forum Clauses in Euro-Bonds' (1972) 11 Colum. J. Transnat'l L. 240, 244–45.

119 Stefano Battilossi, 'Financial innovation and the golden ages of international banking: 1890–1931 and 1958–81' (2000) Financial History Review 141, 154.

corporations. Bond instruments represent a debt that the bondholder who is entitled, as against the issuer of the bond, to payment of the debt, as well as entitled to sell and buy them on the market. Before the bonds are sold to the larger public, the bonds will first be subscribed and bought by a small group of underwriter syndicate banks from the bond issuer for a fee. The syndicate then resells the bonds on the secondary market to a much larger group of potential investors where they can trade, depending on whether there are buyers and sellers.[120]

One of the earliest syndicated eurobond issues already possessed many of the main features of any debt securities issue today. It is also an early example of the interaction between private parties and governments and financial and legal innovation driven by the urge to structure transactions in order to reduce tax burdens specifically and the impact of state regulation generally - in this example at the permission, indifference, or outright demand of state officials to do so. It should also be noted from the outset that other types of financing techniques were already booming during the same era due to the emergence of the eurobond market. Many of them were the result of the emergence of the eurobond market but for the present purposes they are not central.[121]

The first syndicated and dollar-denominated eurobond issue is attributed to a state-owned corporation. The bond issue involved negotiation between an Italian state-owned company Istituto per la Riscostruzione Industriale's (IRI) subsidiary, Autostrade as the borrower, S.G. Warburg & Co., an English merchant bank as the lead manager, and Deutsche Bank and Rotterdamsche Bank as the co-managers (together the Syndicate). First, as to its constituting elements, the eurobond was issued in a foreign currency to both the Italian borrower, who needed US dollars to finance its operations, and the place of issue, the United Kingdom.[122] The eurobond was aimed by the Syndicate to a few selected investors on the market.[123] The US dollar-denominated issue was listed both in recognized exchanges in London as well as in Luxembourg, where the listing requirements were considerable but yet still lighter than those of the London Stock Exchange.[124] It was an offshore investment

120 Fuller in Paterson, Zakrzewski (n 116) 535–38.

121 It was already common to structure new credit to a legal form that would not show as debt on the balance sheet, thus the concept of 'off-balance-sheet treatment', of the debtor. The level of indebtedness of the debtor is typically controlled by creditors through financial covenants - a contractual private regulatory mechanism - on the capital structure of the borrower. Samuel C Butler, 'Legal and Practical Aspects of Nonconventional Types of Financing That Have Developed and Are Now Developing' (1968) Pub. Util. L. 41. Such objectives also contributed to the increasing length of the terms and conditions. For example, the definition 'indebtedness' could exceed one printed page in length, 45.

122 Autostrade $15,000,000 5½ guaranteed bonds, maturing between 1972 and 1978, Gallant (n 113) 12–13; Chris O'Malley, *Bonds Without Borders: A History of the Eurobond Market* (John Wiley & Sons 2014) 23–26.

123 This technique would now be known as 'private placement'. Haentjens, Gioia-Carabellese (n 17) n 72.

124 O'Malley (n 122) 24–25. In practice, it involves the production of a sales document referred to as prospectus the content of which must meet specified content and disclosure standards. For prospectuses, Fuller in Paterson, Zakrzewski (n 116) 535; Haentjens, Gioia-Carabellese (n 17) 30–39. Listing of Eurobonds to stock exchanges could have been a mere formality. Gallant (n 116) 141–42.

in that while otherwise tightly regulated environment, the eurobond issues were largely exempt from local UK regulations applicable to local entities. Structuring the IRI issue as an offshore investment was also a direct requirement set by the UK officials for foreign issuers and the Syndicate. The offshore status combined with the prior experience, expertise, and common language, financial institutions draw market participants to this market.[125]

The Syndicate first underwrote, i.e. bought the bonds, and then sold the bonds to non-UK investors who could afford to invest and found the IRI eurobonds profitable. The main reason behind this structure was state laws, the effect of which the parties concerned sought to avoid. Investors residing in the UK were subject to local exchange controls and withholding of tax rules, whereas foreign investors were not. In contrast, directing the bond issue to UK residents would likely have made it subject to all UK rules and regulations, and quite likely to income tax that is withheld 'at the source' meaning that the investors would receive their funds net of taxes rather than gross. With decreased profit, it would have been challenging for the managers to sell the bonds to potential investors. The legal risk was that the local tax officials would deem the investors to be UK residents to which the tax applied. [126] At that time, England was protectionist over its domestic capital market against foreign borrowers but encouraged foreign investors to use London as a place to raise capital in other currencies.[127] The bonds issued were in bearer form, which meant that the bondholders retained anonymity as the eurobonds were viewed as a *negotiable instruments*[128] essentially meaning that they were transferable to a third party who, as its bearer, was entitled to the interest and repayment and had unencumbered ownership of the eurobond. This differed from, for example, shares and shareholders who would typically have to be registered to a public register. Eurobonds were also tax efficient in that foreign investors were exempted from the English income tax on the interest receipts of the eurobonds.[129] As a negotiable instrument, the eurobond included a whole legal framework of its own. This status was limited as the contracting parties could not establish binding third-party effects of the eurobonds. The aspect of who has the ownership rights over a claim would still be determined on the basis of national laws.[130]

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125 O'Malley (n 122) 18.

126 ibid 23–5, 41; Battilossi (n 119) 165–66.

127 Norbert Horn, 'A Uniform Approach to Eurobond Agreements' (1977) 9 Law & Pol'y Int'l Bus. 753, 742, n 5, referring to Exchange Control Act, 1947, 10 & 11 Geo. 6 c. 14.: Bank of England, E.C. 7 (July 17, 1968).

128 Negotiable instrument is an English law concept that was applied to bonds. Later on, the concept of transferring bonds as physical instruments and negotiable instruments largely disappeared following technological advancement and, as discussed in this chapter, transnationalisation of the market. Fuller in Paterson, Zakrzewski (n 116) 543, 10.3.3.

129 O'Malley (n 122) 23–25, 41; Battilossi (n 119) 165–66.

130 Jan Dalhuisen, *Dalhuisen on Transnational Comparative, Commercial, Financial and Trade Law, The Transnationalisation of Commercial and Financial Law and of Commercial, Financial and Investment Dispute Resolution. The New Lex Mercatoria and its Sources. Volume 1* (6th edition, Hart Publishing 2016) 373.

The news of the IRI issue spread throughout Europe fast. As discussed, US dollars were in high demand outside the US, whereas many US-based investors were keen on investing abroad. New eurobonds were issued first by governmental entities and international institutions, but also exceedingly by corporations.[131] US-based corporations were expanding heavily abroad, especially by investing directly into Europe with US dollars. They would also establish subsidiary presence and operate the business themselves rather than trade directly with foreign corporations. US corporations had concerns of a legal risk. The US government might tighten or introduce new export restrictions, place restrictions on foreign direct investment and introduce new tax regimes applicable to the same. The US government did indeed introduce several measures to prevent US dollar capital outflow to balance the deficit in its foreign payment accounts. Government officials considered this to be the least-cost route in comparison to other policy choices considered at that time as politically and economically unacceptable.[132]

3.4.2 THE REGULATORY ENVIRONMENT

To understand the history of financial regulation is, it is necessary to know about its modern origins.[133] Capital controls were the central regulatory element of the post-World War II regulatory environment in the 1950s and 1960s. These control measures were means to stabilize fluctuations in domestic currencies and domestic markets of individual states. The post-war international financial order represented by the 1944 Bretton Woods Agreement was to promote free trade of goods but not the free movement of capital. In contrast to the more laissez faire approach suggested by some private actors ,[134] state officials favoured interventionist approaches where the former were to serve political and economic goals of states, the powers of which were to be preserved. The use of permanent exchange controls was to be the norm and capital movements were to be controlled by nation states. The use of regulatory measures, such as exchange controls, were even promoted by new public international organizations such as the International Monetary Fund,[135] the policy of which was to explicitly allow its member states to impose restrictions and to use fiscal and monetary measures to combat the possible negative impact of

131 Andre WG Newburg, 'Financing in the Euromarket by U.S. Companies: A Survey of the Legal and Regulatory Framework' (1977–1978) 33 Bus. Law. 2171, 2172.

132 Solomon (n 67) 118, 119.

133 For another summary, Pierre-Hugues Verdier, 'The Political Economy of International Financial Regulation' (2013), 88 Ind. L.J. 1405, 1409–13.

134 Laissez faire and free banking are outside the scope of this research; (n 37).

135 Eric Helleiner, *States and the reemergence of global finance: from Bretton Woods to the 1990s* (Cornell University Press 1996) 25–29.

capital flows.[136] These restrictions remained in force until the 1990s.[137] In that era, nation states could use far-reaching interventionist and selective strategies, virtually of their choosing, from the rate of interest to the distribution and size of credit flows, from one sector of the domestic economy to the other. The private sector, both banking and business, was heavily-regulated in terms of foreign business and their operational sphere was characterized by state protectionism, both in finance and in trade, meaning that the private sector remained in 'a permanent state of liquidity rationing'.[138]

The evidence suggests that prohibitive regulations did not satisfy nor apparently suppress the demand for capital. States, state-controlled entities, and private corporations were in dire need of foreign capital generally, and strong US dollars specifically, following the reconstruction boom after World War II. Simultaneously, for US asset managers that invested on behalf of investors, new business opportunities arose not only in trade but also in foreign direct investment in US dollars, of which they had plenty.[139] Following the logic of supply and demand, this meant the increasing outflow of US dollars to the rest of the world, including Europe. This was a public policy problem for the US in that the outflow led to a deficit in its balance of payments.[140] The size of the eurobond market during its formative years from 1963 to 1975 was hard to measure statistically, but what is known is that the

136 For an overview, Timothy A Canova, 'Banking and Financial Reform at the Crossroads of the Neoliberal Contagion' (1999) 14(6) Am.U.Int'l L.Rev. 1572, 1610–13; O'Malley (n 122) 12.

137 Kaminsky, Schmukler (n 5) 260–62.

138 Lars Jonung, Jaakko Kiander, Pentti Vartia, 'The great financial crisis in Finland and Sweden – The dynamics of boom, bust and recovery, 1985–2000' (2008) 350 Economic Papers, European Commission, December 2008, 11

<http://ec.europa.eu/economy_finance/publications/pages/publication_summary13549_en.htm> accessed 1 June 2019; For an overview of the US regulations on imports and exports, and their impact on transnational corporations, Mehren, Gold (n 42) 10, 11–13; Douglas W Arner; Michael W Taylor, 'The Global Financial Crisis and the Financial Stability Board: Hardening the Soft Law of International Financial Regulation' (2009) 32 U.N.S.W.L.J. 488, summarizing, 509–10:

At the end of the Second World War, reflecting the view that while global trade was desirable, global finance was not, the Bretton Woods structure did not provide a specific hard law, international institution-based structure for finance because *the design was based on the premise that finance would be domestic and subject therefore only to domestic regulation.* (emphasis added)

139 Substantial parts of these assets held by US asset managers might have been actually those of communist states who earned US dollars for their raw material exports and used these assets to buy machinery and grain. Fearing that the US might freeze these assets in the US, these investors chose to invest and divest their assets into the eurobond and eurodollar market, George H Windecker Jr, 'The Eurodollar Deposit Market: Strategies for Regulation' (1993) 9 (1) Am.U.Int'l L.Rev. 357, 361, n 18, n 19; Corinne R Rutzke, 'The Libyan Asset Freeze and Its Application to Foreign Government Deposits in Overseas Branches of United States Banks: Libyan Arab Foreign Bank v. Bankers Trust Co' (1988) 3 Am.U.Int'l L.Rev. 241, 252–53.

140 Solomon (n 67) 118; Legislative History of the Interest Equalization Tax Extension Act of 1969: P.L. 91–128: 83 Stat. 261, 24, November 26, 1969, Hearing before the Committee on Finance, September 3, 1969, Washington, Covington & Burling. (Legislative History of the Interest Equalization Tax (1969)).

market grew rapidly[141] and the investor base was global and included states with closed economies, such as the Soviet Union.[142]

Regardless of the regulatory environment, the 1960s saw the rapid introduction and deployment of financial and legal innovations that circumvented many of the restrictions placed on capital movements or simply existed outside any form of government regulation. Put into legal theoretical context, these market actors acted and relied on fundamental principles of private property, freedom of contract, and pacta sunt servanda. By the 1970s, cross-border capital movements had reached a level so high that it became known as the 'golden era of banking'.[143] This phenomenon has been covered from many angles during the last decades,[144] but nowadays more often as a passing footnote. However, the emergence of the eurobond and the eurodollar market may hold important and timeless observations about the nature of, and the interactions between, finance and law.

For the purposes of this research, the history of the largest bond market in the world, the eurobond market,[145] may also shed light on why the OTC derivatives market came to grow rapidly in the 1980s, why ISDA emerged, why and how it grew to its prominent role, and why the ISDA MA architecture became the industry-standard used by private institutions and sovereigns alike. Cross-currency swaps linked the world's largest capital market, the eurobond market, together. From its early beginning in the 1960s, the eurobond market evolved and became interlinked closely with modern derivatives markets that started its emergence in the 1970s through the increasing demand for interest rate and currency swaps, a type of derivative structure. [146] Local exchange controls were not much of a hindrance for cross-border capital movements.[147]

141 Legislative History of the Interest Equalization Tax (1969) (n 140) 24; Claudio Segre, 'The development of a European capital market. Report of a Group of Experts appointed by the EEC Commission'. November 1966, EU Commission – Working Document, 360–1 <http://aei.pitt.edu/31823/> accessed 1 June 2019.

142 Singer (n 110) 473–74.

143 Battilossi (n 119) 141. It is worth noting that even in such a heavily regulated environment, regulations now considered to be at the core of financial regulation did not yet exist at that time. For example, the existence and enforcement of insider trading laws is by and large a much more recent phenomenon, Kaminsky, Schmukler (n 5) 289.

144 Christopher J Mailander, 'Financial Innovation, Domestic Regulation and the International Marketplace: Lessons on Meeting Globalization's Challenge Drawn from the International Bond Market' 31 Geo. Wash. J. Int'l L. & Econ. 341 (1997); Virginia K Trioa, 'An Overview of the Eurobond Market' (1987) 12N.C. J. Int'l L. & Com. Reg. 331 <http://scholarship.law.unc.edu/ncilj/vol12/iss3/2> accessed 1 June 2019.

145 For an overview of the market size, <https://www.bis.org/statistics/secstats.htm> accessed 1 June 2019.

146 Syndicated bonds, swaps, offshore transactions, and regulation as the drivers for financial innovation precede this era, Battilossi (n 119) 158–59. Financial market data from the nineteenth century is 'less than perfectly reliable and not easy to interpret', Raouf Boucekkin, Fréderic Docquier, Fabien Ngendakuriyo, Henrik Schmigelow, 'Contract Rules in Codes and Statutes: Easing Business Across the Cleavages of Legal Origins' in Michèle Schmiegelow, Henrik Schmiegelow (eds), *Institutional Competition between Common Law and Civil Law – Theory and Policy* (Springer 2014) 61.

147 Richard Roberts, 'Setting the City free: the impact of the U.K. abolition of exchange controls' (2000) 2 J.I.F.M. 2000, 132. Roberts also notes that it was not the abolition of exchange controls that led to the eminence of the City, but how the exchange controls had only reinforced its position as an international

Free movement of capital was one of the fundamental freedoms and public policy objectives of the European integration project from the beginning. In practice, however, these ideals started have practical meaning in the mid 1980s.[148] A short selection of early case law of the European Court of Justice may illustrate the legal problems that hindered the free movement of capital. In Europe, the Treaty establishing the European Economic Community (the EEC Treaty) entered into force on 1 January 1958. Pursuant to Article 67 (1) of the Treaty, the Member States:

> [S]hall, in the course of the transitional period and to the extent necessary for the proper functioning of the Common Market, progressively abolish as between themselves restrictions on the movement of capital belonging to persons resident in Member States and also any discriminatory treatment based on the nationality or place of residence of the parties or on the place in which such capital is invested

The creation of the Common Market and even a common currency to stimulate labour mobility were still merely an academic discussion but nevertheless 'on the table'.[149] The process of official liberalization of capital movements was a slow and a gradual process. EEC member states sought to protect their national capital markets and their balance of payments positions. By the mid 1970s, the Commission of the European Communities had proposed a few drafts for minimum standards for stock exchange listings, prospectus requirements, and uniform regulations for open-end investment companies, but they had not been transposed into legislation. It was at the discretion of the EEC member states as to how regulate finance.[150]

In the dusk of the European integration, the European Court of Justice had to balance its preliminary rulings between what was 'necessary' and the 'proper functioning of the Common market' under Article 67 (1) and did these Articles have *direct effect*, i.e. did they give directly applicable rights to corporations and thus could they be invoked directly or were such rights conditional upon on the adoption of directives.[151] First, the exchange controls could manifest themselves in the form

financial centre, 137; Steffen Hindelang, *The Free Movement of Capital and Foreign Direct Investment* (OUP 2009) 34–41, noting that the United Kingdom and Germany in the late 1970s had understood 'that capital control measures were actually of very limited effectiviness under the economic conditions of the time', and the abolition of exchange controls in these two countries had a significant impact on setting an liberalization agenda for capital movements across the European Economic Community.

148 Arner, Taylor (n 138) 505.

149 Robert A Mundell, 'A Theory of Optimum Currency Areas' (1961) 51 The American Economic Review 657, 661.

150 Newburg (n 131) 2174–75; the first European Community banking directive was introduced in 1977, Haentjens, Gioia-Carabellese (n 17) 8.

151 From the outset, the unavailability of legal remedies under the EEC Treaty for private parties to contest

of custody charges imposed on Italian residents investing in bonds issued by the European Coal and Steel Community on a foreign stock exchange. Deutsche Bank, acting as the custodian, had acted in compliance with the Italian legislation according to which that Italian residents may not, except with ministerial authorization, hold shares in companies having their registered office outside Italian territory or hold shares or bonds issued or payable abroad.[152] In the second case, the question was whether the shares of an Irish company listed in Ireland and England were within the sphere of liberalized capital movements, or could the local exchange controls of Ireland render private contracts unenforceable for trades concluded in England. In other words, the legal question was whether an EC directive had *direct effect* on the free movement of capital or would the local exchange controls trump the directive?[153] The third example case involved an Italian national residing in the Federal Republic of Germany who was charged by Italian authorities for violation of Italian exchange control rules. The Italian national sought to export Italian lire notes from Italy to Germany and the legal question was that the prosecuted was allowed to do so under European law.[154] Regardless of the fragmented and unharmonized market, financial markets flourished first in the form of eurobonds followed by the eurocurrency market.

3.4.3 TAXATION AS THE DRIVER FOR LEGAL INNOVATION

Why did the Istituto per la Riscostruzione Industriale issue its bonds in London rather than New York, US, a traditionally popular financial hub for international bond issues? Perhaps the most significant driver for the emergence and popularity of the eurobond market was the introduction of *the Interest Equalization Tax* introduced by the US Government in 1963. The public policy goal was to prevent the outflow of US dollars abroad in order to rebalance the deficit in the US balance of payments.[155] In its beginning, the Interest Equalization Tax made US private and legal persons liable for a 15 per cent tax for certain acquisitions of US dollar

potentially illegal and protectionist state measures came under criticism, Thomas Buergenthal, 'The Private Appeal against Illegal State Activities in the European Coal and Steel Community' (1962) 11 Am. J. Comp. L. 325.

152 Case 157/85 Brugnoni v Cassa di Risparmio di Genova e Imperia. For discussion, Andrew Evans, 'Exchange control and European Community Law' (1987) 2 J.I.B.L. 1987, 63.

153 Case 143/86, John Richard Alan East and others (Margetts and Addenbrooke) v Thomas Cuddy and Winifred Cuddy, European Court reports 1988 Page 00625. For discussion, Andrew Evans, 'Problems of free movement of capital' (1988) 3 J.I.B.L. 183.

154 Case 203/80, Criminal proceedings against Guerrino Casati, European Court reports 1981 Page 02595. For discussion, Philippe Chappatte, 'Free Movement of Capital in Europe' (1982) 1 Int'l Fin. L. Rev. 35.

155 For a more detailed analysis of the interest equalization tax with references to the regulatory framework that was in existence, as well as political background, Singer (n 110) 469; Legislative History of the Interest Equalization Tax (1969) (n 140).

denominated securities issued by non-US persons who had traditionally issued securities in New York.[156] After the introduction of the tax, investors had to find a new venue to raise capital from the international capital markets. Despite warnings and efforts to liberalize the local market from local regulations, the interest equalization tax law was enacted. It is 'still considered one of the most misinformed financial policies adopted by any administration, proposing a tax that achieved exactly the opposite of what it intended'.[157] While it may have had some success in preventing the outflow of US dollars to certain unwanted regimes, this cannot be ascertained, it did not work as it was supposed to in curtailing the outflow of US dollars. To the contrary, the statistics and its analysis suggest that while new US dollar denominated bond issues in the United States 'virtually disappeared', they reappeared outside the US in ever exceeding volumes.[158]

Interest equalization tax drove business, both US and non-US investors from New York to London and other financial centres where eurobond issues similar to those of IRI saw a surge. This development was partially fueled by the newly-found efforts of some English state officials to attract business to their jurisdiction.[159] However, far from being in favour of liberalization, the Bank of England that was protective over its own authority as was the City of London that opposed the abolishment of the exchange controls and the free movement of capital. Post WWII, The City was becoming 'increasingly adrift from its traditional, pre-1914 internationalist roots' characterized by 'conservatism and preference for the status quo' more than internationalism and free flow of capital. The eurodollar and euromarkets 'flourished entirely autonomously of exchange controls'. [160]

A significant proportion of those new eurobond issues were made by US companies in US dollars used often to finance domestic (US) investments. This effectively meant that the use of eurobond market helped to relieve rather than worsen the US balance of payments problems. This is why the US Treasury encouraged US corporations to use this finance structure. Thus, incentives for financial and legal innovation had at least tacit, if not outright, direct government support while at the same time tax authorities worked under their own imperatives of trying to tax the very same transactions.[161] The additional benefit of eurobonds was, for example, of not having to file a US registration statement mandatory for US

156 Pub. L. No. 88–563, § 2(a) (1964).

157 Ronen Palan, 'International Finance Centers: The British-Empire, City-States and Commercially Oriented Politics' (2010) 11 Theoretical Inq. L. 149, 163.

158 Legislative History of the Interest Equalization Tax (1969) (n 140) 23–25.

159 O'Malley (n 122) 25–32; Legislative History of the Interest Equalization Tax (1969) (n 140); Battilossi (n 119) 165–66.

160 David Kynaston, 'The long life and slow death of exchange controls' (2000) 2 J.I.F.M. 37, 38.

161 Newburg (n 131) 2173; Craig M Boise, Andrew P Morris, 'Change, Dependency, and Regime Plasticity in Offshore Financial Intermediation: The Saga of the Netherlands Antilles' (2009) 45 Tex. Int'l L. J. 377, 381, 430–31; Singer (n 110) 485–87.

bond issues. Eurobonds also relieved some entities from disclosure requirements under the US securities laws.[162] The Interest Equalization Tax was extended multiple times and its effective rate was finally repealed in 1976.[163]

Depending on the situation and likely of the financial resources at their disposal to buy the required legal advice, transnational corporations were in some cases able to repatriate eurodollars back to the US without being subject to dual taxation. As the US government also had an incentive to direct the flows of US dollars back to be invested into the US market - remembering that this was seen as a public policy problem in the beginning and the ratio for enacting the interest equalization tax - the interests of transnational corporations and the state were aligned. Withholding tax could be rendered inapplicable through financial and legal structuring, but this led to further legal risks.[164] By establishing a subsidiary to an offshore jurisdiction with which the US tax treaties under which the US tax regime did not apply, the foreign subsidiary could transfer capital in US dollars to the US parent company legally.[165] This is naturally a simplified summary that only illustrates the fact that capital flows could be structured so as to avoid being caught by a tight regulatory framework. In reality, 'it became necessary for corporations wishing to market convertible debentures [a type of eurodollar financing allowing the investor to convert bonds to equity] to enter an administrative labyrinth of exceedingly complex dimensions'.[166]

Eurobonds were a driver for offshore tax business. Offshore centres were used at the approval of public authorities. Normally it was achieved by establishing subsidiaries to offshore jurisdictions with which the US had signed tax treaties.[167] In fact, such 'treaty shopping' by the US borrowers was encouraged by the US Treasury to bypass the US withholding tax as long as the offshore intermediary maintained some minimum amount of equity capital and was subject to taxation in the offshore centre. If a US corporation wished to borrow funds on international capital markets, a finance company would do it on its behalf by first issuing an eurobond, which would then transfer funds to the offshore intermediary, which in

162 Steward R Jr Bross, 'The United States Borrower in the Eurobond Market––A Lawyer's Point of View' (1969) 34 Law & Contemp. Probs. 172, 176–77.

163 William W Jr Lancaster, 'The Foreign Direct Investment Regulations: A Look at AD HOC Rulemaking' (1969) 55 Va. L. Rev. 83, n 10; Norbert Horn, A Uniform Approach to Eurobond Agreements, (1977) 9 Law & Pol'y Int'l Bus. 753.

164 Legislative History of the Interest Equalization Tax (1969) (n 140) 23, 32, which includes a reference to Canada, the government of which had agreed bilaterally on an exemption for some US regulations with the US, as one channel of repatriating 'hot dollar' flows back to the US from London branches of financial institutions.

165 Butler (n 121) 42–43; Legislative History of the Interest Equalization Tax (1969) (n 140) 27–28, noting also that the repatriation of US dollars back to the US would not necessarily demonstrate the balance-of-payment statistics as a capital inflow but as a financing item.

166 Eric R Fox, 'Financing Foreign Operations Through Domestic Finance Subsidiaries' (1969) 55 Va. L. Rev. 1306, 1310.

167 ibid 1308–11, n 14.

turn would borrow the funds to the US corporation, which in turn would ultimately benefit from the lower withholding tax rate upon repayment.[168]

At the beginning of 1968, the United States took new measures to prevent capital outflows and to repatriate US dollars held abroad by US corporations back to the US. The measures included an executive order,[169] new regulations, and a new regulatory agency, the Office of Foreign Direct Investment.[170] While prohibitive in general, the ratio of some of these policies were to channel some of the capital outflows to certain parts of the world with a strong balance of payments and reserve positions. From the beginning, the new regulations gave rise to difficult questions as to what constitutes 'transfer of capital', legal uncertainty as to their applicability to different forms of new innovative structures, and to 'artificial distortions of normal business practices'.[171] Regardless of the legal uncertainty of what was legal and what was illegal, violations could carry criminal sanctions up to $10,000 fines for both natural and legal persons, and a maximum of 10 years imprisonment.[172] In practice, the US Internal Revenue Services issued rulings approving the use of the finance subsidiary business under the US/Netherlands Antilles tax treaty deemed necessary to finance both US domestic and international corporate activities.[173] Finally, once the US Treasury who had earlier condoned 'treaty shopping', sought to abrogate the US/Antilles tax treaty, the US Congress unilaterally repealed the withholding

168 Hariton (n 52) 315, n 10.

169 Exec. Order No. 11387, Governing Certain Capital Transfers Abroad, Jan. 3, 1968, 33 Fed Reg. 47:

> 1(a) except as expressly authorized by the Secretary of Commerce, from engaging in any transaction involving a direct or indirect transfer of capital to or within any foreign country or to any national thereof outside the United States.
>
> 1(b) '[t]hat any person subject to the jurisdiction of the United States who, alone or together with one or more affiliated persons, owns or acquires as much as a 10% interest in the voting securities, capital or earnings of one or more foreign business ventures shall cause to be repatriated to the United States such part as the Secretary of Commerce may specify.

<http://www.presidency.ucsb.edu/ws/index.php?pid=106173> accessed 1 June 2019.

170 Butler (n 121) 42, noting that the creation of the Office of Foreign Direct Investment and its regulations 'may prove to be the biggest boom to lawyers since the 1950 amendment of § 7 of the Clayton Act', a reference to US antitrust law the scope of which was widened through the enactment Celler-Kefauver Antimerger Act of 1950, 64 Stat. 1225, The American Antitrust Institute, 'Summary of Section 7 of the Clayton Act' (2013) National Press Club – Washington, D.C. <http://www.antitrustinstitute.org/sites/default/files/Section%207.pdf> accessed 1 June 2019. Based on this evidence, transnational self-regulation in professional services dates at least to the 1950s. For transnational self-regulation in professional services, Panagiotis Delimatsis, 'Standardisation in services – European ambitions and sectoral realities' (2016) 41 E.L. Rev. 513.

171 Lancaster (n 163) 101–04. For example, US parent companies were under obligation to repatriate a certain amount of earnings per annum from their subsidiaries to the US which from a tax perspective would mean that the dividends would possibly be subject to dual taxation, both under the US income tax laws and a foreign tax law, 121–25.

172 Charles I Kingson, 'Investment in Western Europe under the Foreign Direct Investment Regulations: Repatriation, Taxes and Borrowings' (1969) 69 Colum. L. Rev. 1, 26–7, n 104.

173 United States General Accounting Office Washington, D.C. 20548, April 12, 1983, 44.

tax on portfolio interest (but not for US equity dividends) as an harmful and anti-competitive measure to US based corporations and governmental entities.[174]

The US regulations further increased eurobond financing. Legal risks created incentives to structure transactions to a form that would render domestic US tax regulations inapplicable with at least tacit if not direct support from the US treasury.[175] If some capital outflows could be curtailed, the regulations created incentives for financial and legal innovation in the form of new financial products and financing techniques.[176]

It was especially transnational corporations based in the US that had made direct investments to European countries by establishing European branches. As these branches required capital, they would issue eurobonds to finance these foreign operations. The markets were still largely regulated nationally through exchange controls, and subject to many other regulations such as prohibition of advertizing of securities as well as regulatory limitations as to how brokers could make contract with potential investors, among others. However, as long as the transactions were made in a currency different to that of individual states, the respective national regulatory agencies had no incentive to prohibit their national corporations from raising capital from international capital markets and probably not even the authority to limit the eurobond and eurodollar markets in their respective jurisdictions since these transactions did not involve domestic currencies.[177]

Eurobonds were effectively self-regulated on a transnational plane. As described by *Robert L Knauss*, while the emergence of the eurobond market was originally an unintended byproduct of a public policy response to the US balance of payments problem, eurobonds now had 'a life of their own'. In general, '[w]hile attorneys sit and worry about legal restraints the financial community just does what is needed to develop an effective financing device to meet needs'.[178] The demand for capital soon extended from the bond market exceedingly dominated by the eurobond market to other types of finance, such as loans or lines of credit. In addition, London interbank offered rate (LIBOR) was being exceedingly used as the standard reference interest rate in finance.[179] While the interest equalization tax had already been repealed in the late 1970s, financial institutions and borrowers still had the incentive not to choose to issue eurobonds first within the US or to offer them to US citizens or

174 Hariton (n 52) 315–16, n 12–14; AW Newburg, 'United States Companies and International Financing' (1986) 20 Int'l L. 763.

175 Lancaster (n 163) 87–90; Singer (n 110) 475.

176 Singer (n 110) 474–77.

177 Newburg (n 131) 2175.

178 Robert L Knauss, 'International Security Markets' (1969) 3 Vand. Int'l 35, 38–42, appendix 'Statistics on European Securities Markets'.

179 Newburg (n 131) 2175–78.

residents as this would have made them applicable to US securities laws generally and particularly the Securities Act of 1933.[180]

3.4.4 PRIVATE NORMATIVITY IN ACTION: THE EMERGENCE OF THE EUROCURRENCY MARKET

Following the boom in the amount of eurobond issues, much of the currencies, especially the US dollar, were left circulating outside the place of their issue. This offshore currency market came to be known as the *eurocurrency market*, having its origins already in the late 1950s. The prefix 'euro' was a misnomer from the beginning as it had nothing to do with continent of Europe per se. In the eurocurrency market, commercial banks acted as intermediaries in currencies that circulate outside the issue country of the currency in question. In other words, eurocurrency trading is a form of offshore financing where both the borrower and the lenders are from countries other than that of the currency of the bond issue. The reason for structuring the eurobond issues under the laws of England was that the local officials allowed and exempted them from local English regulations. The Bank of England allowed this offshore market to develop in London by not intervening, and many of those eurodollars originated from US-based financial institutions fleeing another set of local US regulation.[181]

For example, the US dollars held by a financial institution located in England would be referred to as eurodollars. By depositing and relending currencies for their ultimate borrowers, commercial banks could facilitate business for themselves in foreign currencies. In contrast to dealing in foreign exchange, which was a business on its own, the eurocurrency transactions involved only one currency, for example, a loan in eurodollars, whereas the former always involved more than one currency as the purpose was to exchange one currency to another.[182] Eurodollar lending also provided an impetus for contract standardization in finance, especially in the lending documentation.[183] A decade later, standardized lending documentation would form the basis for OTC derivatives transactions that further evolved into the ISDA Master Agreement architecture through market demand as described in Chapter 5.

180 Horn (n 163) 755–76, noting also that it was already common during that time to apply for a subsequent listing on the New York Stock Exchange which renders the Securities Exchange Act applicable, 756, n 12. The legal uncertainty of the application of the Securities Act of 1933 and the Securities Exchange Act of 1934 deemed ambiguous to extraterritorial transactions gave rise to many legal disputes already at that time, Mehren, Gold (n 42) 15–18.

181 Palan (n 157) 161–63.

182 Edmund MA Kwaw, 'Towards the creation of an international legal regime for the operation of Eurocurrency deposits' (1994) 43 I.C.L.Q. 317, 318.

183 Philip R Wood, 'Sovereign Syndicated Bank Credits in the 1970s' (2010) 73 Law & Contemp. Probs. 7, 8.

Following eurobond issues from approximately 1965 onwards, transnational corporations now had large US dollar deposits at foreign banks or at branches of US banks. eurodollars, dollars circulating outside the US, that is, were used for various types of financing which also meant that a new type of banking services became in demand. This further reinforced the trend towards further transnationalisation of financial institutions that began to establish branches and subsidiaries in other jurisdictions to facilitate trading in different currencies.[184] As was already noted by *Andre WG Newburg*, the term 'Euro' in this context was becoming an even more generic root word as the market was becoming increasingly global and attracted new market participants entered from across the world. However, despite its global nature, it was especially London that retained its predominant role in the euromarket. Eurodollars were first used in short-term interbank markets, but business soon expanded to lending by bank syndicates to now-multinational corporations and governmental borrowers.[185] From the perspective of the US, the quick turn of events did not leave much room for public policy to reverse the developments. The eurodollar market grew at a rapid pace forming 'a huge pool of convertible international liquidity, subject to (virtually) no central bank controls of any sort. Both central and commercial bankers alike, in quiet moments, are appalled by the dimensions of the monster they have created'.[186] The eurodollar market was a financial innovation that eroded national sovereignty as it was not subject to the exclusive control of central bankers; from now on, 'international currency traders would have to be factored into a nation's monetary policy'.[187]

By the end of the 1960s, syndicated eurodollar lending proliferated. In other words, groups of financial institutions began lending a larger sum of credit for one debtor than would be possible to lend by one financial institution. One of the reasons these loan agreements were governed by English law with submission to the jurisdiction of the English courts was that the new interbank-deposit funding market was located in London. This choice would - hopefully - reduce the legal risks that might arise from the jurisdiction of the third-country borrower. Market participants were already familiar with the common law and equity legal system. Following the entry into force of the European convention of 1968 on judgements in civil and commercial matters, the choice of law in international contracts was recognized by the adhering states. This essentially meant that rulings made by

184 Battilossi (n 119) 169; Newburg (n 131) 2172. On the lucrative reinvestment of the eurodollars by transnational banks to developing countries between 1973–1980 and their 'uneasy alliance' with the International Monetary Fund, Richard Bernal, 'Transnational Banks, the International Monetary Fund and External Debt of Developing Countries' (1982) 31 (4) Social and Economic Studies 73.

185 Newburg (n 131) 2172–73.

186 Legislative History of the Interest Equalization Tax (1969) (n 140), quoting *The Economist*, 29–31. 23, 31.

187 Charles RP Pouncy, 'Contemporary Financial Innovation: Orthodoxy and Alternatives' (1998) 51 S.M.U. L. Rev. 505, 525–26.

English courts in accordance with the laws of England would be enforceable in other states in which the European Convention was applicable.[188]

The eurocurrency deposits rapidly increased in amount and size, while at the same time the legal status of the fundamental aspects of trading were unclear. For example, the concept of 'payment', the method of determining the proper law of a eurocurrency deposit contract, and the legal characterization of an international-funds transfers were in this legal grey area. Regardless of this legal risk, there was very little litigation in the eurocurrency deposits. When disputes occurred, it often originated from state action, such as the imposition of exchange controls which then turned into a jurisdictional conflict between states[189] or involved other state actions such as asset freezes.[190] In essence, the eurobond market was both described and placed under the heading and concept of transnational law from early on. The very purpose of eurobonds was to operate in a 'transnational financial dimension' with a degree of self-sufficiency from national legal systems while acknowledging that the latter may restrict party autonomy and possibly 'interfere with the contractual objectives of the parties'. Private international law could offer some answers to the question of which national laws could interfere with these rights but generally, the situation was unclear and in a constant state of flux depending on which governing contract law was chosen out of many.[191] The legal risks of this environment created a demand for strict adherence and compliance to any possible applicable national laws through contract.

188 Wood (n 183) 12–14.

189 Kwaw (n 182) 318, 334–35, 342–43. By the end of the 1970s, the eurocurrency market would become a political arena where the Federal Reserve was seeking control over the eurocurrency market via financial regulation through the Bank for International Settlements, financial institutions were lobbying for general deregulation of their activities and the central banks of England, Switzerland, and Germany were in favour of maintaining the euromarket as beneficial to their own interests, Helleiner (n 132) 135–39.

190 See the high-profile case involving the asset freeze of US dollars held on dollar-denominated account by foreign branches of US banks in Libyan Arab Foreign Bank v. Bankers Trust Co., [1986] L. No. 1567/L. No. 4048 (Q.B.) I, reprinted in 26 I.L.M. 1600, 1603 (1987); Corinne R Rutzke, 'The Libyan Asset Freeze and Its Application to Foreign Government Deposits in Overseas Branches of United States Banks: Libyan Arab Foreign Bank v. Bankers Trust Co' (1988) 3 Am.U.Int'l L.Rev. 241; Daniel Urech, 'Eurodollar deposits and freezing orders: the Libyan assets case revisited' (1988) 3 J.I.B.L. 269

191 Delaume (n 118) 248–53.

3.5 OFFSHORE CENTRES AND TRANSNATIONALISATION OF FINANCE

3.5.1 SHORT HISTORICAL REVIEW OF OFFSHORE FINANCING

By the mid-1980s, 'virtually every major U.S. corporation had at least one Antilles finance subsidiary'[192] and weighting of the arrangement's benefits for US corporations and the decrease in tax revenues,[193] the US finally ended both the tax treaty in its entirety with the Antilles as well as repealed withholding tax on bond interest payments for foreign bondholders. From a tax revenue perspective, the Antilles structure allowed US corporations to deduct interest payments onshore while de facto financing the offshore company by repaying the debt at a higher interest rate than the offshore company had to pay to the eurobond investors. This structure, while legal and promoted originally by the US government itself, had become a strain for public officials, especially the Inland Revenue Service, as was the withholding tax in itself in that it did not generate much revenue but created an obstacle for US corporations and governmental entities for unhindered access to international capital markets.[194] Already before the emergence of the eurobond market, there were many offshore jurisdictions that served the purpose of structuring financial transactions for transnationally operating financial institutions.[195]

One way of structuring eurobond issues for US corporations was to establish offshore holding companies in offshore jurisdictions. These offshore jurisdictions both regulated and taxed the former, and they were often incorporated into jurisdictions like Luxembourg[196], the Netherlands Antilles or domestically to Delaware, US. In the eurobond market, the Netherlands Antilles came to be the most popular offshore jurisdiction since its laws and regulations did not impose withholding or inheritance taxes on nonresidents, it benefited from an income tax treaty in force between the US and the Netherlands, and, like in the UK, its exchange controls did not apply to eurobonds as long as the debt securities of the offshore subsidiary were not sold to residents of the Netherlands Antilles. The US withholding

192 Boise, Morriss (n 161) 379, n 4, 429; Tony Freyer, Andrew P Morriss, 'Creating Cayman as an Offshore Financial Center: Structure & Strategy since 1960' (2013) 45 Ariz. St. L.J. 1297; for an overview, IMF Staff Assessments, 'The International Monetary Fund Offshore Financial Centers (OFCs)' <http://www.imf.org/external/NP/ofca/OFCA.aspx> accessed 1 June 2019.

193 United States General Accounting Office Washington, D.C. 20548, April 12, 1983, Statement of William J Anderson, Director General Government Division Before the Subcommittee on Commerce, Consumer and Monetary Affairs Committee on Government Operations House of Representatives on Federal Efforts to Define and Combat the Tax Haven Problem <https://www.gao.gov/products/121055> accessed 1 June 2019.

194 Boise, Morriss (n 161) 423–26; Hariton (n 52) 315–16, n 8, n 14.

195 For an overview of the transnationalisation of banks, financial innovation, and the capital outflows in 1890–1931, Battilossi (n 119) 145–157.

196 Kingson (n 172) n 191.

of tax did not apply provided that as long as the interests paid by US companies to the Netherlands Antilles subsidiary were taxed at the Netherlands Antilles at prevailing rates and that the subsidiary was a capitalized and independent entity conducting substantive business activity.[197] The choice over place of incorporation of a foreign finance subsidiary was driven also by other tax and regulatory considerations the level of corporate income taxes and stamp taxes among them.[198]

3.5.2 THE GRISHAM EFFECT OF OFFSHORE CENTRES

Structuring a transaction as 'offshore' carries a sinister ring to it already because it involves technical vocabulary and may involve a jurisdiction located typically in a tropical surrounding. This image is referred to as the 'Grisham Effect' which refers to novelist John Grisham's book 'The Firm' and its movie adaptation with perhaps both fascinating and notorious but misleading portrayal of offshore investments generally, and the Cayman Islands specifically, as a centre for illegal activities such as tax avoidance and money laundering.[199]

The emergence of offshore jurisdictions is an illustration of how transnational law may operate. Like any type of business nowadays, offshore structuring often employs derivatives structures[200] which makes it reasonable to examine the matter to some degree. As characterised by *William Vlcek*, the use of the term 'onshore' is absent without the use of 'offshore'. Being onshore is often equated to being situated in the domain of a regulated sovereign state. Being offshore is equated with less regulation and less taxation by a somehow less sovereign state. The image might be that the offshore centres and their users are more or less 'free riders on global public goods'. Many of the exotic islands equated with being 'offshore' not only in geographical terms but also from state regulation are common-law based and hold close connections either to England or the US. [201] Offshore refers here to transactions where the contracting parties structure a transaction in whole or in part under a law that would not otherwise be applicable to the contracting parties or the contract they make. With this definition, any jurisdiction can be an offshore center.

197 Similarly, a Delaware subsidiary would have to meet similar requirements to be eligible for tax benefits. Newburg (n 131) 2190–94.

198 Kingson (n 172) 46–47; Christopher R Brown, 'Reagan Threatens the Eurobond Market' (1982) 1 Int'l Fin. L. Rev. 4

199 Boise, Morriss (n 161) n 329.

200 Del Wright Jr, 'Financial alchemy: How Tax Shelter Promoters Use Financial Products to Bedevil the IRS and How the IRS Helps Them' (2013) 45 Ariz. St. L.J. 611.

201 *William Vlcek, Offshore Finance and Small States: Sovereignty, Size and Money* (Springerlink 2008) 18–21.

Tradable goods and services, commodities, are determined by supply and demand and law provides a framework within which trading takes place. As profane it may sound, the level of profanity - but not its truthfulness - depends on how one conceptualizes law, law itself is also a tradeable commodity. States advertise and are ready to supply when there is a market demand for a particular type of law.[202] On the demand side, market participants can choose which law shall apply to their transactions and if they are dissatisfied with the chosen laws or courts, they can switch to a more accommodating jurisdiction and often still have these foreign rulings enforced by their respective national courts.[203] This system of choice-of-law and choice-of-court is upheld, favoured, and accommodated by the states themselves.[204] According to a survey conducted by the Oxford Institute of European and Comparative Law and the Oxford Centre for Socio-Legal Studies in 2008,[205] market participants use this option. Over 90 per cent of the respondents viewed the possibility to choose the governing law of the contract as either important (42 per cent) or very important (49 per cent).[206] In addition, over 90 per cent of the respondents chose a foreign contract law either occasionally (41 per cent) or often (44 per cent).[207] On the supply side, states as suppliers of law commodities have both direct, such as tax revenues, and indirect, such as the attractiveness of financial industry service providers, incentives to enter the market for legal rules.[208] It is worth stressing that '[a]ny regulation that attracts or repels businesses also contributes or detracts from the state's overall economic environment and thereby potentially affects the welfare of all participants in this environment';[209] hence, the emergence of a transnational law market.

202 Larry Ribstein, Erin O'Hara, *The Law Market* (OUP 2009) 66; Eidenmüller (n 58) 707, 709.

203 In the EU, Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the Law Applicable to Contractual Obligations:

'Article 1
Any law specified by this Regulation shall be applied whether or not it is the law of a Member State,

Article 2 (1)
A contract shall be governed by the law chosen by the parties. The choice shall be made expressly or clearly demonstrated by the terms of the contract or the circumstances of the case. By their choice the parties can select the law applicable to the whole or to part only of the contract.'

For overriding mandatory provisions, ibid, Article 9.

204 Eidenmüller (n 58) 709–12.

205 The Oxford Institute of European and Comparative Law and the Oxford Centre for Socio–Legal Studies 'Civil Justice Systems in Europe: Implications for Choice of Forum and Choice of Contract Law – A Business Survey' <https://www.fondation–droitcontinental.org/fr/wp–content/uploads/2013/12/oxford_civil_justice_survey_–_summary_of_results_final.pdf> accessed 1 June 2019; Ribstein, O'Hara (n 202) 81–82.

206 ibid Question 15.

207 ibid Question 16.

208 Eidenmüller (n 58) 707, 712–13.

209 Ribstein, O'Hara (n 202) 74.

3.5.3 On arbitrage generally

Craig M Boise and *Andrew P Morriss Boise* claim that the use of offshore jurisdictions is more of a feature than a problem of international finance: there will always be differences among legal regimes and *arbitrage* opportunities, which means that some party will benefit from any imbalance, were that benefit derived from time, information, or regulation.[210] Like offshore finance, arbitrage can be seen as something sinister and ethically questionable, equated with outright theft.[211] *Financial innovation* carries a similar bad reputation and has become 'almost a byword for egregious profiteering by wily bankers at the expense of innocent customers'.[212] *Financial arbitrage* in economic terms, put simply, means profiting from a price difference, or benefiting in some other way, from differences in two markets. For example, buying a commodity in one market for one price, and selling the same commodity in another market at a higher price with a profit margin that exceeds the cost of selling it in another market, is financial arbitrage. *Regulatory arbitrage* is the act of benefitting from a difference between the economics of a transaction and the design of a regulation. Financial regulation can require that a bank must hold a certain amount of regulatory capital to shield it from economic risks, but this regulatory burden can be reduced typically by using derivative structures.[213] More generally, regulatory arbitrage is about seeing opportunities in the regulatory framework to make a profit.[214] For example, if two counterparties are subject to two different regulatory regimes under which risks are measured differently, the counterparties may be able to use this difference to their benefit.[215]

In its negative meaning, regulatory arbitrage could mean that the lower cost of operating in one jurisdiction derives from the lower quality of regulation (lower environmental protection comes to mind) and a market participant using this

210 Boise, Morriss, (n 161) 377; Markus Krebzs, *Securitization and Structured Finance Post Credit Crunch: A Best Practice Deal Lifecycle Guide* (Wiley 2011) xii, 13, noting that 'Beware of unexplainable "arbitrage" in any shape or form [...] it is for you to figure out whether there is real justification behind it or if it looks plain "dodgy"' 37; Kevin E Davis, Anna Gelpern, 'Peer-to-Peer Financing for Development: regulating the Intermediaries' (2010) 42 N.Y.U. J. Int'l L. & Pol. 1209, '[c]ompetition is in part a function of the inherent mobility of capital; however, governments have historically sought to restrict their citizens' capacity to invest abroad', and also mentioning the famous 'backfiring' of the Interest Equalization Tax, n 111.

211 Edvard J Kane, 'Shadowy Banking: Theft by Safety Net' (2014) 31 Yale J. on Reg. 773. Kane seems to view financial innovation as something as outright socially harmful and unethical with no redeeming qualities.

212 Avinash Persaud, *Reinventing Financial Regulation – A Blueprint for Overcoming Systemic Risk* (Apress 2015) 139.

213 Panayiota Koulafetis, *Modern Credit Risk Management. Theory and Practice* (Macmillan Publishers Ltd 2017) 8–11; Jordan Barry, 'On Regulatory Arbitrage' (2011) 89 Texas Law Review, <https://ssrn.com/abstract=1859750> accessed 1 June 2019.

214 Annelise Riles, 'Managing Regulatory Arbitrage: A Conflict of Laws approach' (2014) 47 Cornell Int'l L.J., 63, 71–72, also discussing how regulatory harmonization often means uniformity of rules. The benefits of uniformity are taken for granted but uniform financial regulation may bring additional risks into the financial system, 77–83; Chapter 6.

215 Krebzs (n 210) 37.

opportunity engages in this behaviour without market ramifications. However, if the costs are lower in one jurisdiction due to the fact that these local regulations achieve their objective more efficiently than other regimes, regulatory arbitrage can be benefical.[216] In finance, some financial institutions engage in regulatory arbitrage whereas most do not.[217] Identifying the risks that regulatoru arbitrage can pose to the financial system is one thing, and efficiently regulating the same is a whole another matter.[218] From a regulatory perspective, the problem is that regulating financial entities efficiently in one jurisdiction may matter little if these efficiently regulated financial entities are linked and exposed to poorly regulated and risky financial entities operating elsewhere.[219] To add more complexity to the whole question of what does arbitrage mean and is it harmful and to whom, financial innovation and regulatory arbitrage is not only allowed but are often favoured or even outright required by regulators themselves.[220] Eurobonds were from the beginning a means to raise capital from a transnationalised market at a cheaper rate than it would have been to raise it from a regime that imposes withholding taxes on the acquisition of bonds. It was financial arbitrage in the sense that the price of raising capital was smaller due to a regulatory difference between England and other jurisdictions. Further, it was regulatory arbitrage in the sense that under English law eurobond issues were exempted from some regulatory and tax requirements under English law as long as other strict regulatory requirements were met.

Smaller offshore jurisdictions used for structuring of transactions are vulnerable to onshore pressure from states. However, new offshore hubs are likely to emerge or survive depending on the viability and suitability of their own legal systems for structuring a transaction as well as their political arrangements and connections to other states.[221] '*Structuring*' a transaction means, from a legal perspective, ensuring

216 Ethiopis Tafara, Robert J Peterson, 'A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework' (2007) 48 Harv.L.Rev 31, 52.

217 Nicole M Boyson, Rüdiger Fahlenbrach, René M Stulz, 'Why Don't All Banks Practice Regulatory Arbitrage? Evidence from Usage of Trust-Preferred Securities' (2016) 29 (7) The Review of Financial Studies, 1821, arguing that misaligned managerial incentives are not first-order reasons for particular type of regulatory arbitrage.

218 Hossein Nabilou, Alessio M Pacces, 'The hedge fund regulation dilemma: direct vs. indirect regulation' (2015) 6 Wm. & Mary Bus. L. Rev. 183; Andreas Engert, 'Transnational hedge fund regulation' (2010) 11 E.B.O.R. 329, 332, 357–62, noting again the important observation worth repeating that in a transnational setting, '[t]he causes and effects of systemic events cut across the territorial boundaries of jurisdictions', 377.

219 Kathryn Collard, 'Advantages of a co-regulatory OTC derivatives regime' (2014–2015) 46 Geo. J. Int'l L. 877, 887.

220 See for example a financing instrument referred to as 'contingent convertible bonds' or in market jargon 'CoCos'. They are a form of bonds that private market participants have innovated to meet regulatory capital requirements under the CRD IV regime in the EU. There are reasons to believe that Cocos 'will not save taxpayers from exposure in times of financial crisis and could actually contribute to making matters worse', Persaud (n 212) 45–47; Tracy Chiyedza Maguze, 'EU bank recapitalisation and the bail-in option: an analysis of the effects of mandatory bail-in on creditors' property' (2016) 5 UCLJLJ 207.

221 Boise, Morriss (n 161) 382–83, 429.

that any given transaction follows all applicable or even possible applicable laws while allocating capital efficiently within these parameters. Structuring is made easier by relying on standardized contracts. As to the claim that these transactions go untaxed, the use of offshore structure means that some tax regime structures are inapplicable, while other tax regimes are applicable due to their reliance on bilateral tax treaties between states, for example.[222] The difficulty lies in the differentiation, from a legal point of view, between a transaction intended to provide a tax benefit, which is legal, and creating a transaction for the perhaps sole purpose of creating a tax benefit, when it may or may not be illegal. In the US, the tax authorities have sought to address this problem through codifications and regulations, but the result has been that the benefits of using tax shelters simply outweight the cost of not using them, even when there is a risk of costly litigation.[223] In addition, when the tax authorities claim victory over some tax shelters, they are overmatched as previous tax shelters become replaced with new ones.[224]

3.5.4 FINANCIAL OFFSHORE CENTRES WERE AND ARE REGULATED

Without a doubt and like all forms of finance, offshore centres can also be used as hubs for outright illegal activities and illegal tax evasion. It is general knowledge that much of the most traded goods globally are subject to state control or are outright illegal and so assumedly the financing of their tradings is as well. States can also drive unwanted offshore competition off the market - sometimes maybe to their own fiscal detriment.[225] While there are public calls, regulations, and international treaties to combat illegal tax evasion, which is a central public policy concern,[226] their effectiveness in transnational finance and the transnational law market remains an open question. International and supranational treaties generally promote and obligate states to promote free movement of goods, services, people, and capital. These two public-policy objectives of creating an effective tax regime against tax shelters, while retaining the free movement of capital, could be seen to be pulling in opposite directions. Be that as it may, transnational corporations are routinely

222 Bross (n 162) 179–181, 186–87. Eurobond convertibles could be structured as tax-free transactions and as an interest-deductible security for the acquiring company. Butler (n 121) 43.

223 Wright (n 200) 659–64.

224 Wright (n 200) 653–54.

225 For the central elements of the onshore and offshore dynamics, Boise, Morriss (n 161) 377; Andrew P Morriss ‘Changing the Rules of the Game: Offshore Financial Centers, Regulatory Competition & Financial Crises’ (2009) 15 NEXUS 15, arguing that the GFC opened up a chance for powerful states to attack unwanted offshore competition, <https://scholarship.law.tamu.edu/facscholar/186> accessed 1 June 2019.

226 Thorsten Beck, Chen Lin, Yue Ma, ‘Why Do Firms Evade Taxes? The Role of Information Sharing and Financial Sector Outreach’ (2014) The Journal of Finance LXIX, 763.

accused of illegal tax evasion. There is evidence that this is rare and allegeldly is limited to only some of the largest transnational groups that deploy a strategy of deliberate tax evasion.[227]

At least at one point in time, the more commonly used offshore jurisdictions have been supervised, regulated, and compliant with international regulatory standards.[228] A study from 2012 by *Michael Findley* and others found that shell companies in tax havens were 'significantly more likely to comply with the rules than providers in OECD countries like the United States and Britain' and that 'providers in poorer, developing countries were also more compliant with global standards than those in rich, developed nations'.[229] Equating the use of offshore regimes as automatically illegal or socially harmful, or even to be in some 'gray area' of finance, is problematic to say the least. Literature evidence demonstrates sovereign involvement in the very creation, regulation, and legitimatization of off-shore companies and offshore financing, as discussed in this Chapter. Yet, a narrative of tax haven jurisdictions attracting foreign capital with lax regulations for tax avoidance and/or off-balance-sheet accounting purposes and the problems they pose to effectiviness of financial regulation.[230] The narrative is common.[231] In their stark criticism towards such narratives, *Richard Gordon* and *Andrew P Morriss* claim that there is a problem in legal scholarship:

> '[T]ax justice' literature is driven by its incorrect assumptions about money, business, finance, and government. The assumptions are disguised by often overheated rhetoric and pseudoscientific, or completely unscientific calculations. […] what they are advocating is a fundamental reordering of global finance in ways that we contend would reduce social welfare.[232]

It may be that, while highly regulated, the US and England are relatively more optimally regulated than the regulatory frameworks of other developed nations. As

227 Patrice-Hubert Petit, David Chekroun, 'Governance of transnational groups: what are the stakes? What are the challenges?' (2016) 6 I.B.L.J. 617, 621.

228 Boise, Morriss (n 161) 429.

229 Michael Findley, Daniel Nielson, Jason Sharman, 'Global Shell Games: Testing Money Launderers' and Terrorist Financiers' Access to Shell Companies' (2012) Griffith University

<https://www.gfintegrity.org/wp-content/uploads/2014/05/Global-Shell-Games-2012.pdf> accessed 1 June 2019. The research notes how '[i]t is more than three times harder to obtain an untraceable shell company in tax havens than in developed countries […] It is easier to obtain an untraceable shell company from incorporation services […] in the United States than in any other country save Kenya' 2, 21.

230 Emily Lee, 'The shadow banking system: why it will hamper the effectiveness of Basel III' (2015) 30 J.I.B.L.R. 373.

231 Richard Gordon, Andrew P Morriss, 'Moving Money: International Financial Flows, Taxes, and Money Laundering' (2014) 37 Hastings Int'l & Comp. L. Rev. 1.

232 ibid 1.

noted by *Philip Morriss*, offshore (lax regulation) and onshore (strict regulation) are not the two ends of a uni-dimensional spectrum.[233] For reason or the other, market participants favour these two jurisdictions as described in Chapter 4.

Calls for international and transgovernmental cooperation in this area are common and indeed much work has been done by organizations such as the OECD and the European Commission to implement a coordinated international standards and public exposure of tax secrecy, i.e. confidentiality, regimes. *Ed Morgan* goes on to conclude that transgovernmental cooperation can be seen as a façade for sovereign interests and, '[i]n the end, global tax rules are no more and no less than what states, in all of their differences and similarities, say they are.[234] Considering that the evidence suggests that the most economically powerful state, the US, allowed, justified, and promoted the use of off-shore regimes, even physically 'onshore' in its respective geographical territories, to redirect US dollars back to the US, the filling of perceived regulatory vacuums efficiently with international co-operation seems like chasing a mirage. When it comes to doing politics on the issue of tax havens, this might not matter for those who benefit in one way or the other from the narrative.

3.5.5 FINANCIAL OFFSHORE CENTRE AS A RACE TO THE BOTTOM?

Is regulatory arbitrage then a 'race to the bottom'? Do transnational corporations flock to the most deregulated and lightly taxed jurisdictions? One case example suggests that the answer is a decisive 'no' to both questions. Delaware, US, a historically popular place to incorporate a US company for structuring offshore transactions,[235] as the place of domicile, a Delaware state agency claims 'The State of Delaware is a leading domicile for US and international corporations'. More than 1,000,000 business entities have made Delaware their legal home. More than 66% of the Fortune 500 [a list compiled and published by Fortune magazine listing the 500 largest US corporations by their total revenue -author's note] have chosen Delaware as their legal home'.[236] Delaware actively competes for business and when given the choice, market participants often choose Delaware law as the governing law of their contracts and outside the place of incorporation, corporations have little connection to Delaware otherwise.[237]

233 Morriss (n 222) 15, 22.

234 Ed Morgan, 'International tax law as a ponzi scheme' (2011) 34 Suffolk Transnat'l L. Rev. 69, 115; for criticism towards the lax regulatory attitude towards British offshore centres, Philip Morriss, 'Financial Regulation, Taxation and Economic Management in British Offshore Finance Centres: Critical Reflections on the Foot Review' (2010) J.C.L.S. 391.

235 Kingson (n 172) 1, for initial public offerings, 33–40, for interest equalization tax structuring, 40–47.

236 <https://corp.delaware.gov/aboutagency/> accessed 1 June 2019.

237 Ribstein, O'Hara (n 202) 81–82.

AC Pritchard notes that Delaware does not compete on prices nor even taxation but more with the combination of the liability protections for directors, the predictability and stability of Delaware law especially in regard to its corporate governance rules, the quality of the judges of the judiciary upholding the liability protection in its case law, among others.[238] Based on his empirical study, *Jared A Elliass* suggests that bankrupt debtors choose Delaware as the bankruptcy venue because of the predictability of the Delaware laws. Claims that there are hidden and ethically questionable motives behind this argument, the self-interest of legal experts, among others, found no support from the research.[239] Being more optimally regulated is enough in competition over economic activity that generate revenues for the states to run in the first place. The transnational law market is real and one driver out of many for the supply and demand in this market are local tax regulations, but as the case of eurobonds demonstrates, it can be a decisive factor for driving markets from one jurisdiction to another.

Whereas taxation on physical consumer goods or an income tax on individual natural persons is relatively easy to comprehend and be turned into a public policy and then through representative democratic decision into legislation, the same does not necessarily apply to intangible assets such as financial instruments. To conclude this subchapter, a case study worth revisiting briefly reveals how Sweden sought to tax financial transactions by issuing a levy on equity transactions executed by brokers established or domiciled in Sweden. The tax law was proposed in 1983,[240] the tax was increased from 0.5 percent to 1.0 percent, and its scope was widened in 1986. The tax law was finally repealed in its entirety in 1991.[241] To summarize, the outcome of the tax was that foreign investors were discouraged from using Swedish brokers to execute their transaction involving securities of Swedish corporations traded in a Swedish market place. [242] Following the entry into force of the tax law,

238 Pritchard (n 49) 78 Univ of Cincinnati Law Review 473, 476–83; Marcel Kahan, Michael Klausner, 'Standardisation and Innovation in Corporate Contracting (Or the Economics of Boilerplate)' (1997) 83 Va. L. Rev. 713, noting the high quality of legal advice also as a factor, 723.

239 Jared A Elliass, 'What Drives Bankruptcy Forum Shopping? Evidence from Market Data' (2018) 47 (1) The Journal of Legal Studies 119.

240 Regeringens proposition, 1983/84 [Government Proposal – authors note]: 48. The explanatory part of the Government Proposal reveals (9–10) that the primary justification and public policy objective for the transaction tax was that because the rate of Swedish wages remained stagnant, the persons engaging in the lucrative equities trade should collectively be taxed through the proposed levy.

241 Regeringens proposition 1991/92:34 om upphävande av lagen (1983:1053) om skatt på omsättning av visa värdepapper. [Government proposal for the repealment of the Financial Transaction Tax – authors note]. The government proposal notes how the trade in the Swedish equity markets had diminished considerably and liquidity (an essential component of markets to operate) had decreased especially for large and medium-sized Swedish companies.

242 John Y Campbell, Kenneth A Frooth (1993), 'International Experiences with Securities Transaction Taxes' in Jeffrey A Frankel (ed) *The Internationalization of Equity Markets* (University of Chicago Press 1994) 277, 280–85 <http://www.nber.org/chapters/c6276.pdf> accessed 1 June 2019; Johan Almenberg, Magnus Wiberg, 'Skatt på finansialle transaktioner', Penning- och valutapolitik 2012,1, Riksbanken, 85, 88–91, noting also that the complexity of financial products and the market makes it exceedingly difficult to reach tax neutrality across different asset classes.

it became harder for Swedish corporations to finance their activities with equity issuances as the tax made them less appealing to foreign investors who could invest in other non-taxed securities around the world.[243] Regarding Swedish investors, all that was required to avoid the transactions being treated as taxable on the basis of residence was to open a non-resident account in London and trade through a foreign broker in Swedish securities.[244] Alternatively, the same economic outcome could be achieved by structuring and trading in derivatives that did not fall under the stated category of taxable transaction under Swedish law.[245] The finding is that that perhaps well-intentioned but less well designed local tax regimes do create unintended consequences in the transnational law market. The absence of proof for offsetting public welfare benefits of regulatory intervention seems not to hinder its enactment.

3.6 TRANSNATIONAL CUSTOMARY LAW OF INTERMEDIATED SECURITIES SYSTEMS

Intermediated securities systems, where securities such as eurobonds are held, contributed 'to a spectacular upsurge in financial collateral transactions' in collateralized derivatives, among others, and gave rise to regional law reforms both at the regional and international levels.[246] As financial collateral is also an important part of the ISDA MA architecture and these intermediated systems are an example of bottom-up law making, private normativity, the facilitative role that states may have in this process, and the evolution of transnational customary law of finance, it is useful to revisit in some detail the private origins and normativity of these private regulatory mechanisms that emerged already in the 1960s. Soon thereafter, this area evolved into transnational lex mercatoria of book-entry systems that rendered domestic laws on contract and proprietary laws more or less irrelevant and conflict of law rules redundant once the autonomous transnational development in this area had taken place.[247]

In principle, states can enact new law products to facilitate market interactions. As the eurobond example demonstrated, the product may be that a state decides not to act and not to apply certain laws for certain products, and if so required,

243 Campbell, Frooth (n 242) 280–85; Almenberg, Wiberg (n 242) 88–91.

244 Persaud (n 212) 193–95, noting also that under current laws, this should not be possible due to a regulatory requirement to declare the beneficial ownership of securities held on a foreign account.

245 Campbell, Frooth (n 242) 280–85; Almenberg, Wiberg (n 242) 88–91.

246 Goode and others (n 85) para 15.44.

247 Jan Dalhuisen, *Dalhuisen on Transnational Comparative, Commercial, Financial and Trade Law Volume 3 Financial Products, Financial Services and Financial Regulation* (6th edition, Hart Publishing 2016) 56–60, 441–43.

make exemptions for certain product categories. Provided there is indeed a demand for a new law product, it will establish itself on the market. Other countries have a tendency of imitating each other in this regard. [248] Eurobonds display uniform international legal characteristics important for their interpretation by courts and arbitrators. The eurobond market satisfied the market demand for a new type of a financial product that was legally structured in a particular way as to ensure that it was compliant with national laws and regulations. It was for the issuers and the arrangers to decide where the issue would take place, which courts would hold, which would be the governing law of the issue, and how the financial institution acting as a bond agent on behalf of the bondholders would carry out its responsibilities. The transnationalisation process of eurobonds was not the result of political discourse, because there was no need for one, while being a perfectly legal method of raising capital from investors around the world.

The eurobond market was also the driver for new technological innovations for new types of financial infrastructure already in the late 1960s. Physical bearer instruments such as eurobonds were in many ways risky. Eurobonds could be stolen or be destroyed. Importantly there was a risk of fraud and forgery of the same. To obtain payment of principal or interest, the bondholder had to physically deliver the bond or interest coupon to a certain place of payment.[249] There was a market demand for legal certainty over a record of ownership and subsequent transfer of title. To address the problem, market participants innovated and finally founded a new method of holding, trading, and dealing of investments. A solution could be found from central security depositories, a centralised and computerised system, to overcome logistical and legal problems of cross-border transfer of physical bond certificates and coupons. The technological solution for such problems was the *immobilization* of physical certificates, to facilitate settlement without physical delivery, and the creation of new legal concepts, *fungibility* of security interests being a central one.[250]

To repeat, there was a market demand for more convenient, efficient, and safer trading that needed legal recognition and *facilitative state legislation*. Physical bearer instruments, such as bonds, were replaced with a new legal innovation, intangible and immobilized security interests. The only physical instrument left

248 Eidenmüller (n 58) 707, 732, also mentioning the emergence and prevalence of the limited liability company, a private construct, in the United States as another example; Anthony Ogus, 'Competition between national legal systems: a contribution of economic analysis to comparative law' (1999) 48 I.C.L.Q. 405.

249 Fuller in Paterson, Zakrzewski (n 116) 547.

250 Giovanni Group: Cross-border Clearing and Settlement Arrangements in the European Union. Brussels, November 2001, 9, n 11, <https://ec.europa.eu/info/system/files/first_giovannini_report_en.pdf> accessed 1 June 2019; Marida Bertocchi, *Euro Bonds: Markets, Infrastructure and Trends* (World Scientific Series in Finance 2014) 60–61. Immobilization of security certificates was not a new invention as it dates back to late 19th century Germany, ibid.

was an immobilized ‘global bond’ that represented a whole issue of securities. In time, even the global bonds would be left in history when the issues turned from immobilized to *dematerialized*, meaning that the securities existed only as book entries on compturers.[251] Instead of transferring a physical bearer instrument from one party to another, the transfer would be achieved by debiting and crediting of book-entry accounts operated by the CSD in the computer systems of which a security instrument was held. [252]

From a more detailed legal perspective, the immobilization means essentially that physical certificates would typically be replaced by a single ‘global receipt’ that would be held by a specific custodian who holds and administers securities and other financial instruments for third parties. The bond agent would act as an intermediary between the bond issuer and the respective bondholders. Instead of holding a specific physical security with a specified series number, a security holder would now have a proprietary claim, simply put a co-ownership right, to a pool of assets with other holders of equivalent securities which the global receipt represents. These pools would then be separated to book-entry accounts in which individual bondholders would ‘keep’ their respective securities.[253] These accounts were to be operated by specialized custodian institutions. Private companies, the founders of which were financial institutions such as Euroclear Bank and Cedelbank based in Belgium and Luxembourg, became an elemental part of trading by the end of the 1960s. The increasing amount of bond issues led to the formation of a private trade organization, the Association of International Bond Dealers, that was to self-regulate the market with its own rules and standardize ‘trading habits’.[254] The business of financial infrastructure was from the beginning characterized by a high-degree of specialization focused on new technologies in an identifiable community that was by its nature distant from politics and even other business areas.[255] By the mid-1990s, the two competing corporations had expanded their business in clearing and settlement. Eurobond settlement formed only a small fraction of their overall services offering, and the rapid increase in cross-border trading in securities made the legal recognition of these private mechanisms a public policy issue given that problems in this area transcended the borders of national jurisdictions.[256] Euroclear and Clearstream are major actors in post-trading business and their private rules

251 Fuller in Paterson, Zakrzewski (n 116) 547.

252 Joanna Benjamin, ‘Determining the situs of interests in immobilised securities’ (1998) 47 I.C.L.Q. 923, 923–24.

253 ibid.

254 Gallant (n 113) 17–18; O’Malley (n 122) 40–42. For a detailed account, Norman (n 9).

255 Norman (n 9) 5.

256 Richard Dale, ‘Clearing and settlement risks in global securities markets: the case of Euroclear’ (1998) J.B.L. 434, 435, 441.

have been both recognized and the use of which encouraged by the European Commission.[257]

Going back to the 1960s, it was not a coincidence that the central securities depositories were established in Luxembourg and Belgium. Given that the UK officials sought to retain the status of England as an offshore hub, it was for the market participants to find another jurisdiction as to ensure the inapplicability of the laws of the UK to their eurobond issues. The officials of both Luxembourg and Belgium recognized a common core of purposes in enacting targeted legislation that would facilitate trading: to provide technical services for the issuers, to serve a communication function between the parties concerned (the issuer, the bond agent, and the bond holders) and to centralize authority on behalf of creditor pools that, given that securities are traded all the time, were scattered in different jurisdictions, and changed constantly.[258] The equity based concept of trust was especially facilitative in this regard, the existence of which required no enactment of any specific law in order to be able to provide legal certainty. In comparison Luxembourg and Belgium, as civil law countries, had to enact separate legislation that created 'trust-based representation devices' that emulated equity-based trust structures. Such legislation was to the author's understanding *lex specialis* intended for transnational use, meaning it was not to be used for domestic and municipal transactions. Following the enactment of Arrêté grand-ducal of 22 December 1972,[259] the laws of Luxembourg recognized a convention fiduciaire (trust agreement) and représentantion fiduciaire (trustee). From a legal perspective, the central question was what law would apply to the book entry accounts held at CSDs, the legal status of which also had to be ascertained.[260] Often the 'global bond' was deposited to a custodian also located in London.[261]

The determination of the proper law applicable to the security rights (and later on, their use as a collateral) would point the question of proper law towards private international law. Under these rules, the applicable law would be determined by a *lex situs* rule, a general rule of English private international law. Under *lex situs*, the applicable law would be defined by the location of the asset. One problem out of many in the practical application of *lex situ*s was that book-entry securities are by their nature intangible and thus have no physical location. It was also problematic

257 Rosalind Bufton, Eduardo Martínez Rivero, 'Clearstream: General Court confirms Commission Decision' (2010) 1 (10) EC CPN.

258 Frederic C Rich, 'International Debt Obligations of Enterprises in Civil Law Countries: The Problem of Bondholder Representation' (1980–1981) 21 Va. J. Int'l L. 269, 278.

259 Arrêté grand-ducal du 22 Decembre 1972, concernant la representation fiduciaire, Memorial (Off. Gaz.) Dec. 29, 1972.

260 Rich (n 258) 'International Debt Obligations of Enterprises in Civil Law Countries: The Problem of Bondholder Representation' (1980–1981) 21 Va. J. Int'l L. 269, noting the benefits of the common law trust structure in this regard.

261 Benjamin (n 252) 923, 924.

that while the concept of *lex situs* was recognized in civil law countries, such as Italy and France, the interpretation of *lex situs* differed across jurisdictions making it very difficult to know which law would be applicable.[262] As summarized by *Georges R Delaume*, discussing the issue as to how to overcome the inconsistency between the transnational character of eurobonds and their localization to a specific legal system if the existing private international law rules are applied, '[t]here is absolutely no clue as to the reasons determining the choice of one rather than another legal system as the proper law of the loan'.[263]

To date, it remains unclear where financial instruments sit from a legal perspective, but they very much exist and operate under transnational customary law. The Hague Convention on Certain Rights with respect to Securities held with Intermediaries (The Hague Convention), was a process driven by private actors that took less than two years to complete. According to The Hague Convention, the primary rule is that the location of the account is determined by the governing law of the relevant account agreement, i.e. the contracting parties may in principle choose the governing law. Nonetheless, under the Financial Collateral Directive (FCD),[264] the location is the place of the securities account (*lex conto sitae*).[265] As noted by *Michael Huertas* and *Aikaterini Theodosopoulou*, under current EU law, the location of a relevant account could be determined to be situated at least in five different places. Planned harmonization attempts at the EU level are not only unlikely to clarify the issue, but to the contrary, might negatively affect existing market practices.[266]

Bond transfers grew in volume and so did the custody chains from one custodian to its sub-custodians that in turn could be located in different jurisdictions. What would be the applicable law to a eurobond held by a sub-custodian which was to face insolvency? Would the bondholder be recognized as the owner of the bond under the insolvency laws of the jurisdiction applicable to the bankruptcy estate of a sub-custodian?[267] The reality was, and still is, that national laws would cause

262 Paul Avanzato, Wilde Sapte, 'How to Use the Collateral Carousel' (1998) 17 Int'l Fin. L. Rev. 29, 31; Benjamin (n 252) 925.

263 Delaume (n 118) 246.

264 2002/47 Directive of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements [2002] OJ L168/43.

265 Sandeep Gopalan, 'A demandeur-centric approach to regime design in transnational commercial law' (2007–08) 39 Geo. J. Int'l L. 327, 340–44, n 72, n 73, 379; Article 4 of the Hague Convention <https://assets.hcch.net/docs/3afb8418-7eb7-4a0c-af85-c4f35995bb8a.pdf> accessed 1 June 2019; the principle of *lex conto sitae* was adopted in earlier EU directives, which is why it was also chosen as the basis of the FCD, Klaus Lober, Ewa Klima, 'The implementation of Directive 2002/47 on financial collateral arrangements' (2006) 21 J.I.B.L.R. 203, 210–11.

266 Michael Huertas, Aikaterini Theodosopoulou, 'Collateral and the Capital Markets Union: what the EC Green Paper tells us and what needs doing' (2015) 30 J.I.B.L.R. 415, 421–22.

267 European Central Bank, 'The Payment System: payments, securities and derivatives, and the role of the Eurosystem' (2010), the definition of 'custody risk', 119:

fragmentation to the custody chain as the laws of other nations could become applicable to book-entry accounts located outside the CSDs jurisdiction, which all would have their say on the question of *situs*. In addition to tangible/intangible distinction, property laws often distinguish also between movable and immovable things. The nature of book-entry securities as intangible *and* movable called for the creation of new form of situs or legal location so that applicable law could be identified to book-entry securities.[268] As mentioned, unlike English law, civil law systems did not recognize trust structures and fungibility concepts, which is why there was a market demand for new legislation. Following the market demand for legal certainty, both Luxembourg and Belgium introduced new legislation to accommodate eurobond trading which differentiated them from other civil law countries. Both states enabled the utilization of a structure similar to equity based trust, identified the concept of fungibility, and allowed account holders to hold a proprietary claim for securities held by custodians recorded on their book-entry accounts.[269] For example, under the Luxembourg law, the *lex situs* of securities was the law where the book entry on the CSD is held.[270] While this development was welcomed, the situation was far from ideal in other respects, starting already from the question that the location of the book-entry account was unclear. In addition, each jurisdiction that was somehow affected by the issue could challenge the interpretation about the location of the assets and its legal enforceability.[271]

In contrast to this transnationalisation of law, the integration of the European Common Market was still in its infancy and would lag far behind. From the perspective of financial infrastructure providers:

> [I]ntegration came late to the party, long after technological advance, financial innovation and market liberalization had wrought changes in structures that served national markets in Europe.[272]

The risk of a loss being incurred on securities in custody as a result of a custodian's insolvency, negligence, misuse of assets, fraud, poor administration or inadequate record-keeping.

<https://www.ecb.europa.eu/pub/pdf/other/paymentsystem201009en.pdf> accessed 1 June 2019.

268 Nina Hval, 'Credit Risk Reduction in the International Over-the-Counter Derivatives Market: Collateralizing the Net Exposure with Support Agreements' (1997) 31 Int'l L. 801, 802, 814–15.

269 Peter S Smedresman, Michael A Kenney, 'Solving the Puzzle of Cross-border Securities Pledges' (1996) 15 Int'l Fin. L. Rev. 15, 17–18.

270 Hval (n 268) 815, n. 55.

271 However, market participants might still have decided to use trust-based devices in Belgium and Luxembourg, the legislation of which allowed for the trustee to act swiftly on behalf of the holders of eurobonds (and other securities) in its own name should there be a reason to protect the interests of the bondholders. In other jurisdictions, this might not have been possible. See the source referred to in Rich (n 258), n 89.

272 Norman (n 9) 5.

Integration through financial regulation not only 'came late to the party' but actually *renationalized* a transnational market. It can be said that the market participants trading eurobonds created efficient trading in inefficiently separated markets which were costly and risky as the regulatory, legal, and fiscal environment followed the lines of nations while the eurobond market was transnational in its nature and bottom-up law-making flourished. The functionalities of CSDs, clearing, settlement, depository services, are market services characterised by rules of contracts and technology of a regulatory, legal, and fiscal nature.[273] It was only in the 1980s when securities were offered harmonization processes at the EU level.[274]

There was a market demand for better law that would reduce legal risks and would facilitate more efficient trading in eurobonds. The evolution was driven by the possibility to choose the governing law of the eurobonds, and the private/public governance regime (the laws of Belgium and the Netherlands) led to a cumulative process of improvements in governance structures.[275] In the EU, the public policy makers and regulators noted how the market demand for efficiency had indeed created efficient trading infrastructure 'in the presence of inefficiently separated markets' that followed the lines of national legal orders. One particular financial product, the eurobond, had been the central driver in this development.[276] However, it may well be asked why these markets became subject to renationalization not to state level but to the supranational local level of the European Union. The eurobond market was already functioning on a transnational basis but nevertheless became subject to local EU financial regulation borne out of perhaps questionable motives. The regulatory framework did not take the efficient eurobond market as its foundation but began to localize a transnational phenomenon through local regulation.[277] While this issue cannot be further examined in this research, the conclusion is that the eurobond market laid down foundations for transnational contracts and private regulatory mechanisms that operated autonomously on a transnational plane but not independently of their legal and regulatory frameworks of states. This is private normativity in action, which gave rise to further contractual standardization discussed in the following Chapter.

273 Giovanni Group (n 250) Annex II, 64.

274 Haentjens, Gioia-Carabellese (n 17) 25–27.

275 Wolfgang Kerber, 'Institutional change in globalization: transnational commercial law from an evolutionary economics perspective' (2008) 9 German L.J. 411, 426–31, discussing the regulatory competition and its drivers between legal systems.

276 See the first report of the Giovanni Group, a component of the EU's policy objective known as the Lisbon Strategy, Giovanni Group: Cross-border Clearing and Settlement Arrangements in the European Union, Brussels, November 2001, the objective of which was to 'assess the current arrangements for cross-border clearing and settlement and to identify the main sources of inefficiency relative to the corresponding arrangements for domestic transactions', i, 20, https://ec.europa.eu/info/system/files/first_giovannini_report_en.pdf, accessed 1 June 2019.

277 Dalhuisen (n 247) 663, 696; Chapter 5, n 132.

4. TRANSNATIONALISATION OF THE OTC DERIVATIVES MARKET

4.1 THE SUPPLY AND DEMAND FOR SHARED CONTRACTUAL LANGUAGE

The law and practice of finance is largely based on contract. Both in the eurobond market and in the lending market, 'global contractual standardisation' and 'consensus as to appropriate market practice' was achieved already by the early 1980s. States are but one type of market participant in finance that adhere to these market practices.[1] Transnational contracts serve as an evidence of and an artefact of private normativity and bottom-up law making. Originally the outcome of spontaneous action of day-to-day transactions, i.e. repeated interactions between market participants, transnational contracts can become standardized in a coordinated effort and design by private trade organizations and their members, both public and private. The more the users, the more beneficial transnational contracts can become to the members of a business community.[2] First drafted into existence by small specialized trade organizations to meet the market demand for simplified negotiation processes,[3] both sophisticated and less sophisticated market participants use, in vast majority of transactions, standard-form contracts in many segments of the financial markets.[4] Concurrently, private trade organizations who draft transnational contracts have grown from small clubs of a few members, to communities of hundreds of members of arguably the most influential financial and other private entities in the world, as well as sovereigns to their supporting service organizations.[5] It is evident that any

1 Joanna Benjamin, David Rouch, 'The international financial markets as a source of global law: the privatisation of rule-making?' (2008) 2 Law & Fin. Mkt. Rev. 78.

2 Bryan H Druzin, 'Anarchy, Order, and Trade: A Structuralist Account of Why a Global Commercial Legal Order is Emerging' (2014) 47 Vand. J. Transnat'l L. 1049; The benefits and detriments of standardized business contracts was also acknowledged by the state officials behind the Iron Curtain, Josef Rohlik, 'Trading with socialist partners' (1974) 4 Ga. J. Int'l & Comp. L. 362, 380–83; George J Roman, 'Socialist conflict of laws rules and practice in east-west trade contracts' (1975) 7 Law & Pol'y Int'l Bus. 1113, discussing 'self-regulatory contracts' and 'contracts without law'; in terms of arbitration, since communist countries had 'accepted the customary law of international trade, most commissions will refer directly to that law to interpret international trade terms and determine liability under the contract', Sanford B King-Smith, 'Communist Foreign-Trade Arbitration' (1969) 10 Harv. Int'l. L. J. 34, 96.

3 Sean M Flanagan, 'The Rise of a Trade Association: Group Interactions Within the International Swaps and Derivatives Association' (2001) 6 Harv. Negot. L. Rev. 211.

4 Mark R Patterson, 'Standardisation of standard-form contracts: competition and contract implications' (2010–2011) 52 Wm. & Mary L. Rev. 327.

5 Flanagan (n 3) 238–41. For the current members list of ISDA <http://www2.isda.org/membership/members–list/> accessed 1 June 2019.

amendments to the existing transnational contracts can be disseminated almost instantly to the members of their respective business communities.

Especially the larger financial transactions are typically arranged under transnational contracts created by private trade organizations which collaborate with industry practitioners, regulators, and leading law firms across jurisdictions.[6] Transnational contracts are not static but adaptive to change. The market for transnational contracts has also matured in that the basic structures, documents, and processes have been settled upon and tested by market participants and by national courts.[7] For a lawyer specializing in repurchase or repo transactions, the often-used contract is the Global Master Repurchase Agreement (GMRA) created and updated by the International Capital Markets Association (ICMA) headquartered in Zurich and established in 2005 following the merger of the International Securities Market Association (ISMA) and the International Primary Market Association (IPMA).[8] In securities lending, the Global Master Securities Lending Agreement published by International Securities Lending Association established in 1989 is the standard contract.[9] For lawyers who specialize in syndicated loan arrangements,[10] the standardized agreement used in the transaction is in many cases a product of The Loan Market Association (LMA) established in 1996 and headquartered in London.[11] There are also multi-product standard agreements that cover repurchase agreements, securities lending, and derivatives alike, such as those published by the European Banking Federation established in 1960.[12] For derivatives lawyers, the most likely option is the ISDA Master Agreement (ISDA MA).[13] For a long time, these different transnational contracts have been interlinked because seemingly different market segments operate in parallel. Take for example traditional bank lending and OTC derivatives which are seemingly different areas of finance. In reality, and from early on, transnational financial institutions started to use OTC

6 Agasha Mugasha, 'Global Financial Transactions and Jurisdictional Fragmentation: Inconsistent Decisions by Leading Trans-Atlantic Courts' (2010–2011) 29 Penn St. Int'l L. Rev. 553, 560.

7 Agasha Mugasha, 'International Financial Law: Is the Law Really "International" and Is It "Law" Anyway?' (2011) 26 B.F.L.R. 381, 447–49.

8 <https://www.icmagroup.org/About-ICMA/history/> accessed 1 June 2019.

9 <https://www.isla.co.uk/> accessed 1 June 2019.

10 A syndicated loan, also known as a syndicated bank facility, is a loan offered by a group of lenders – referred to as a syndicate – that work together to provide funds for a single borrower to disperse credit risk. International syndicated loans can be traced to the end of the 18th Century, Goodwin v. Robarts (1875), L.R. 10 Exch. 337 (Eng. Ex. Ch.); affirmed (1876), (1875–76) L.R. 1 App. Cas. 476 (U.K. H.L.) in which the court analyzed the customary practices relating to international bonds.

11 <http://www.lma.eu.com/> accessed 1 June 2019.

12 <https://www.ebf.eu/home/european-master-agreement-ema/> accessed 1 June 2019.

13 For an overview of ISDA, LMA and ICMA, their objectives and the standardized contracts they offer, Stanyo Neukov Dinov, 'The Role and Function of Private Trade Associations as a Private Regulator in Making Markets More Efficient and Stable: The ISDA, The ICMA and The LMA in Comparative Review' (2017) 16(4) British Journal of Economics, Management & Trade 2.

derivatives products also in connection with lending with their existing corporate customers as evidenced by standardized loan documentation.[14]

For the sake of simplification in this Chapter, ISDA Master Agreement (ISDA MA) refers both to the 2002 version and the 1992 version, which are built on the same architecture and fundamentals, and form the core of all derivatives transactions executed under it.[15] ISDA MA is a product of a private trade organization known as The International Swaps and Derivatives, Inc. established in the mid-1980s. The creation of ISDA MA, and the whole OTC derivatives market, was the outcome of spontaneous actions by market participants to respond to the peculiarities of OTC derivatives trading in its modern dawn in the 1970s and 1980s. Each drafting and transaction were intentional and deliberate acts, co-ordinated by many, but the resulting products evolved at a rapid pace. The OTC derivatives market emerged spontaneously as further discussed in Chapter 5.

Regardless of the type of an occurrence that has repercussions on the market, it is reflected in a transnational contract. From the definition of standardized definition as to what constitutes a 'business day',[16] to forces of nature that affect such definition in an unexpected manner[17] and from government decisions[18] to the introduction of a new currency[19] and all the way to the effective collapse of a whole banking system,[20] or terrorist attacks,[21] every issue is dealt with contractually. Market participants can exercise their right to amend standardized terms and conditions as to their choosing but such deviation should be drafted carefully so as to avoid legal uncertainty from arising from ambiguous drafting.[22] The commercial

14 Christian A Johnson, 'At the Intersection of Bank Finance and Derivatives: Who Has the Right of Way?' (1998–1999) 66 Tenn. L. Rev. 1 1998–1999, 1. In his study, Johnson reviewed the loan documentation of 129 loan transactions of which ninety-two contained references to associated derivative transactions, 26–27.

15 Norman Menachem Feder, 'Market in the Remaking: Over-the-Counter Derivatives in a New Age' (2017) 11 Va. L. & Bus. Rev. 309, 343–44.

16 Claude Brown, 'Defining the Business Day' (1995) 14 Int'l Fin. L. Rev. 42

17 ISDA, 'Hurricane Sandy Guidance' (October 29, 2012), Second Update (October 30, 2012) < https://www.isda.org/a/uViDE/hurricane-sandy-guidance-oct-29-2012.pdf> accessed 1 June 2019.

18 ISDA white paper, 'Brexit – CCP Location and Legal Uncertainty' August 2017; Edoardo Muratori, 'Governing law and jurisdiction clauses of the ISDA Master Agreement: legal basis and impact of Brexit' (2017) 38 Comp. Law. 95.

19 Geoffrey Yeowart, 'Preparing for the Euro' (1998) 17 Int'l Fin. L. Rev. 19; Simon Deane, 'The Euro: implications for Hong Kong' (1998) J.I.B.L. 13 383, 385–86.

20 Udaibir S Das, Michael G Papaioannou, Christoph Trebesch, 'Effects of Russia's 1998 Debt Crisis on the Domestic Banking Sector' IMF Working Paper, 2012, WP/12/203, describing the Russian government's moratorium on certain foreign payments by Russian residents, and its repercussions on the standardization of CDS contracts; Rym Ayadi, Patrick Behr, 'The future for credit derivatives markets: The eminence of regulation' 27–29, 11 April 2015, <https://www.researchgate.net/publication/242492908_The_future_for_credit_derivatives_markets_The_eminence_of_regulation> accessed 1 June 2019.

21 For example, following the 9/11 terrorist attack, the New York stock markets were closed for four business days which was taken into consideration in the following version of the ISDA MA architecture. Paul C Harding, *Mastering the ISDA Master Agreements*, (3rd edition, Pearson Education Ltd 2010) 227.

22 Ebo Coleman, 'Cross-Default Confusion' (1997) 16 Int'l Fin. L. Rev. 49

decisions are expressed in the legal documentation, and their creation involves a multitude of different experts in addition to lawyers. Financial modelling requires appropriately drafted legal documentation capable of addressing risks and capturing the commercial intention of a transaction.[23]

Cross-default clauses, a typical provision of any financial contract, serves as an example of what is meant by interconnections in the financial markets. Cross-default clauses 'basically state that 'If you default on any agreement with any other party, you also default on this agreement and must immediately settle up'.[24] If a counterparty defaults under any other agreement it has entered into with a third party, such default would be 'imported' to, i.e. also constitute a default under the other agreement(s) of the defaulting corporation. Simply put, a default under a loan agreement is a default under a derivatives agreement and vice versa. It depends on the wording of the cross-default clause when the non-defaulting market participant can exercise this right.[25] If market participants invoke these clauses simultaneously across markets, there is a great change that the transnational market dries up of liquidity. This may potentially lead to cascading events of default transnationally and in systemic proportions. [26]

A long case-law history directly concerning the ISDA MA architecture exists in English court praxis as reflected in *Lehman Brothers Special Financing Inc v National Power Corporation & Anor*.[27] Far from being some type of closed and secret community in regards to the ISDA MA architecture, ISDA has published publicly available user's guides early on,[28] on the ISDA MA architecture, which have also been relied upon by English courts as evidence as to the intent behind and the ratio of individual contractual terms of the ISDA MA architecture.[29] Naturally, courts of different jurisdictions can interpret transnational contracts and their provisions in different ways. These rulings affect the choices and contractual arragenements transnational financial institutions do in the transnational law market. When it comes to ISDA MA, market participants may wish to choose their counterparties depending on which insolvency laws, either those of English law or the US law given that large dealers are in these jurisdictions, would be applicable in the event

23 Panayiota Koulafetis, *Modern Credit Risk Management. Theory and Practice* (Macmillan Publishers Ltd 2017) 165.

24 Philip H Harris, 'Recent Market Events and the Foundation for Global Market Crises: A Lawyer's Perspective' (1999) 4 Fordham Fin. Sec. Tax L. F. 25, 26.

25 Coleman (n 22).

26 Harriss (n 24) 26–31; Roy Goode, Herbert Kronke, Ewan McKendrick, *Transnational Commercial Law, Texts, Cases and Materials* (2nd edition, OUP 2015) para 15.72.

27 Lehman Brothers Special Financing Inc v National Power Corporation & Anor [2018] EWHC 487 (Comm).

28 Daniel Cunningham, 'Swaps: Codes, Problems and Regulation' (1986) 5 Int'l Fin. L. Rev. 26, 26, 31.

29 Lehman Brothers Special Financing Inc v National Power Corporation & Anor [2018] EWHC 487 (Comm) 39, 77.

of counterparty default. National insolvency laws and the public policy choices they represent outweigh contractual provisions. For the same reason, transnational financial institutions may switch their location from London to New York or vice versa, or, alternatively, amend the existing ISDA MA provisions to ensure that the contract reflects and is in compliance with the local insolvency legislation applicable to a counterparty.[30]

The same set of facts may bring different outcomes depending on the jurisdiction. The contractual intent may become recharacterized to something else by courts in the application of local laws.[31] To ensure legal certainty, market participants often choose particular laws as the governing law of their contracts and certain courts. While this can reduce legal risks, seemingly unrelated state laws can still have an impact on transactions if they are interpreted in a way that conflicts with transnational practice as further discussed in subchapter 5.8.4.

Financial transactions are accompanied by *legal opinions*. To identify and control legal risks, market participants request legal opinions from each jurisdiction deemed relevant for a transaction. With legal opinions, market participants can control, at least to some degree, the risk arising from the contracting parties as well as issues arising from state legislation, property laws, bankruptcy regimes, and collateral issues - generally those issues that contracting parties cannot override through contract. A legal opinion is a legal document typically drafted by a qualified lawyer in relation to the laws of the jurisdiction that is the subject of the opinion. It addresses various legal issues that relate to a transaction. The legal opinion may indicate how the laws are likely to be applied and interpreted in connection with a transaction by courts and regulators.[32] This is not a new phenomenon. As put forward already by *Oliver Wendell Holmes*, people pay lawyers to argue for them before judges or

30 James Grand, Perry Sayles, 'Bankruptcy Code Trumps ISDA' (2009) 28 Int'l Fin. L. Rev. 34.

31 ibid.

32 Sarah Paterson, 'Legal Opinions' in Sarah Paterson, Rafal Zakrzewski (eds), *McKnight, Paterson and Zakrzewski on the Law of International Finance* (2nd edition, OUP 2017) 414–51. Requesting Legal opinions have been market practice at least from the early 1980s, Royal Bank of Canada, Group legal department, 'Legal Opinions from Borrowers' (1983) 2 Int'l Fin. L. Rev. 3:

> [I]t is of fundamental importance to banks to know that the representations and warranties with regard to factual and legal matters are true as stated in the credit agreement;

In time, legal opinions became longer and filled with qualifications 'with the result that a recipient must have thought that everything was wrong with the document and nothing right', Philip R Wood, 'Sovereign Syndicated Bank Credits in the 1970s' (2010) 73 Law & Contemp. Probs. 7 16; Stanley Keller, 'Legal Opinion Practice at a Crossroads' (2014) 69 Bus. Law. 917, noting that while the qualifications are customary practice, lawyers still include long qualifications for the fear of liability for the absence of the same. Legal opinions are uncertain if, and like most of the time, they have not been 'tested' in courts meaning that a court has not given its interpretation on the material correcteness of what has been stated in the legal opinion; Markus Krebzs, *Securitization and Structured Finance Post Credit Crunch: A Best Practice Deal Lifecycle Guide* (Wiley 2011) 126–27.

to be advised in such a way as to keep them out of court. Lawyers are taught to predict the incidence of the public force that the courts yield.[33]

The legal opinion standardized by ISDA came to be generally known as *netting legal opinions* and *collateral opinions*. In essence, market participants are required, through a regulatory requirement discussed further in Chapter 5, to find out that would the non-defaulting party to the ISDA MA be allowed to terminate the transactions upon counterparty default also when that counterparty is declared bankrupt or is otherwise made subject to some collective liquidation or reorganization procedure. National insolvency laws generally can ‘trump’ contractual arrangements and in the OTC derivatives market, the ability to use bilateral close-out netting upon counterparty default is of paramount importance for market participants. Already in 1997, ISDA had arranged for netting opinions from 23 jurisdictions for the 1987 and 1992 versions of the ISDA MA.[34] According to *Alastair Hudson*, ‘derivatives law’ is not necessarily even an independent discipline itself if viewed from a national standpoint.[35] Furthermore, while not referring to a transnational element of derivatives in this connection, he notes:

> [T]wo things define derivatives law practice as a particular discipline in practice more than anything else: first, the standard market documentation which constitutes a form of closed knowledge about the techniques of that marketplace; and, secondly, *the particular commercial practices* and mathematical techniques which have given rise to the derivatives instruments themselves.[36]

Transnational method can help to identify how the commercial practices that turn into transnational contracts come into existence and how they interact with state-made laws and regulations.

4.2 STATE LAW TRUMPS TRANSNATIONAL LAW

Cases and court rulings concerning transnational contracts are followed very closely by the industry practitioners. Trading can be affected by many unforeseen events. For this reason, transnational contracts include terms and conditions that could be characterized as private regulatory mechanisms that were discussed in subchapter 2.7. The objective of contractual solutions is for market participants

33 Oliver Wendell Holmes, ‘The Path of the Law’ (1997) 110 Harv.L.Rev 991.

34 Bob Wessels, ‘Close-out netting in the Netherlands’ (1997) 12(5) J.I.B.L. 187, 193–94.

35 Alastair Hudson, *The Law on Financial Derivatives* (5th edition, Sweet & Maxwell 2012) para 0–29.

36 ibid para 0–32 (emphasis added).

to ‘allow fact finding to take place and market solutions to be found’ instead of potentially unnecessary terminations of transactions. In practice, the contract could stipulate that the other party has an opportunity to ‘cure’ the situation within a few business days before the other party can exercise its termination rights.[37] For example, the defaulting party can remedy the situation and be able to discharge its obligations by transferring the affected transactions to another of its offices located in an unaffected jurisdiction.[38]

While all this may sound relatively simple, a practical example on the issue of *recharacterization risk* is useful in identifying the legal issues at stake in cross-border finance. Consider a cross-border loan where the parties to the transaction have chosen English law as the applicable law and English courts as the applicable jurisdiction. The borrower is incorporated in England, viewing the transaction from the perspective of English law, the creditor is domiciled in France, and finally, the guarantor of the debtor is located in Germany. At least three state legal orders are connected to the transaction which all view with different concepts and even with differening mindsets. The transaction, a loan, is thus subject to three legal conceptualizations. This means that it is possible that the same set of facts may bring different results depending on how local courts apply their respective local laws to the transaction. Perhaps the debtor is unable to meet its obligations which is an eventuality that the parties have addressed in the loan documentation. In contractual language, non-performance is the most obvious ‘event of default’, a term that allows the non-defaulting party to take actions against the defaulting party. Should the transaction end up in a dispute, a local court would first look at private international law to determine whether it has the competence to act and, if yes, which law is applicable to the contract. This is within the powers of the contracting parties. However, while private international law could direct the dispute to be settled by English courts in accordance with the laws of England, mandatory rules of local laws reflecting public policy choices remain relevant in many respects.[39]

Consider that the debtor is declared bankrupt. The insolvency laws of England applicable to the debtor could suggest that the payment instalments the debtor has made to the creditor constitute preferential treatment of one creditor over the others, and, for this reason, the creditor needs to return the payments it has received back to the bankruptcy estate. Bankruptcy laws very typically include provisions on so-called ‘suspect periods’, or moratoriums, which is a certain time before the declaration of insolvency under which payments made from the bankruptcy estate

37 For example, in force majeure events introduced in the ISDA 2002 MA architecture, this so-called waiting period is eight ‘Local Business Days’, Harding (n 21) 231.

38 Harding (n 21) 255.

39 Simplified example used here is taken from a more nuanced and thoroughly analyzed example in Paul Sebastianutti, ‘What is This Thing Called International Financial Law – Part 2’ (2009) 3 Law & Fin. Mkt. Rev. 155, 158

can be viewed to be made with the intention of transferring assets away from a corporation for the benefit of some creditor(s) at the expense of other creditor(s). While it may be that the creditor did not know about the impending bankruptcy of the debtor, a court could still *recharacterize* the contractual intent of the parties as being preferential. Questions such as these became elemental in the OTC derivatives industry where the market participants saw that the right to terminate all OTC derivatives transactions upon counterparty default due to insolvency as a public policy issue discussed further in chapter 5.

In contrast to commercial transactions in which arbitration is more common, market participants in finance have favoured ordinary courts as the forum for settling disputes. Importantly, litigation is still a rare occurrence. Restructuring of a transaction, by for example extending repayment schedules to avoid default and refinancing of existing obligations, contractually is much more common than litigation.[40] Private market participants are not in the market to litigate, but they 'are aware of and act in accordance with background private law as well as merchant norms.'[41]

4.3 NEW YORK LAW AND ENGLISH LAW

4.3.1 DRIVERS BEHIND POPULARITY

The financial industry relies on state courts and state laws in disputes concerning their transnational activities. According to a 2013 International Arbitration Survey conducted by PwC, a private consultancy firm, and Queen Mary, University of London, the financial industry favours court litigation over arbitration with 82 per cent of respondents favouring the former as the most preferred choice of dispute resolution mechanism.[42] Market participants favour English-American common law. According to the survey conducted by the Oxford Institute of European and Comparative Law and the Oxford Centre for Socio-Legal Studies,[43] the preferred choice of governing contract law was English law 21 per cent as the first answer

40 P Durand-Barthez, 'The "governing law" clause: legal and economic consequences of the choice of law in international contracts' (2012) 5 I.B.L.J. 505, 514.

41 Robert Wai, 'Transnational Private Law and Private Ordering in a Contested Global Society' (2005) 46 Harv.Int'l L.J. 471, 475–77.

42 PwC and Queen Mary University of London, 'Corporate Choices in International Arbitration: Industry Practices' (2013) 7 < https://www.pwc.com/gx/en/arbitration-dispute-resolution/assets/pwc-international-arbitration-study.pdf> accessed 1 June 2019.

43 The Oxford Institute of European and Comparative Law and the Oxford Centre for Socio–Legal Studies 'Civil Justice Systems in Europe: Implications for Choice of Forum and Choice of Contract Law – A Business Survey' (2008) (The Oxford Survey) <https://www.fondation-droitcontinental.org/fr/wp-content/uploads/2013/12/oxford_civil_justice_survey_-_summary_of_results_final.pdf> accessed 1 June 2019.

and 23 per cent of total answers.[44] An overwhelming majority of the respondents (59 per cent) thought that that English law was the most used governing law by anyone conducting cross-border transactions followed next by Switzerland (13 per cent) and the US (11 per cent).[45]

For the respondents, the five most important factors for determination of the governing law of the contract are, from the most important to the least important: first, the contract law applicable to the contract; second, the fairness of the court outcomes; third, the absence of corruption; fourth, the predictability of outcomes; and fifth, the quality of judges and courts.[46] It is not a new finding that in a transnational setting, English language is the common language of international business and finance, and that the contracts in this field are written in the Anglo-Saxon style.[47] In doing so, transnational lawyers and law firms have been creating 'new privatized means and new modes of trans-state dispute processing'.[48] However, these transnational actors 'are captured within essentially archaic systems of organization and legitimation' of the state and thus do not operate truly transnationally.[49]

ISDA MA is by default subject either to English law or the laws of the state of New York and the jurisdiction of English courts or the courts of the state of New York, respectively.[50] The interactions between derivatives trading and national laws led to debate and analysis relating to how to address legal risks in the future creating 'a healthy reflexive relationship between the courts and legal practice'. This interaction occurs particularly in London and New York where the litigation most often takes place.[51] Courts pave the way for the future conduct of business by setting binding precedents in the construction of the terms in finance documents.[52] The reasons for the popularity of English law as the law governing the ISDA Master Agreements and governing also many other kinds of transnational contracts are claimed to be both historical and contemporary. English law is often seen as particularly attractive as the governing law of financial transactions because in general terms it offers certainty,

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44 ibid Questions 17.1 and 17.2.

45 ibid Question 18. For the institutional reasons and the non-legal factors contributing to the popularity of some jurisdictions over the other, Raouf Boucekkin, Fréderic Docquier, Fabien Ngendakuriyo, Henrik Schmigelow, 'Contract Rules in Codes and Statutes: Easing Business Across the Cleavages of Legal Origins' in Michèle Schmiegelow, Henrik Schmiegelow (eds), *Institutional Competition between Common Law and Civil Law – Theory and Policy* (Springer 2014) 59–77.

46 (n 42) Question 19.

47 John Flood, 'Megalawyering in the global order: the cultural, social and economic transformation of global legal practice' (1996) 3 Int'l J. Legal Prof. 169, 190.

48 ibid 201.

49 ibid 201.

50 Hudson (n 35) paras 2–205–206, 10–02–06.

51 Mugasha (n 6) 577–78.

52 Simon Morgan, Jonathan Kelly, 'Banks Seek New Strategy for Financial Disputes' (1999) 18 Int'l Fin. L. Rev. 13.

stability, predictability, and commercial pragmatism because of the economic power of the UK, and because of the accrued financial expertise of the English courts.[53] From a commercial and financial perspective, the main driver for this choice can be found from equity that apparently allows for a more dynamic and responsive law for commercial and financial transactions in comparison to civil law countries in terms of, for example, fiduciary duties and the concept of contract.[54] It is true that civil law countries have imitated trust structures in their own legal orders, as was discussed in chapter Chapter 3.6. English courts usually adopt a literal approach in the interpretation of the wording of standard form contracts as the courts generally view that professional market participants are in charge of the risk allocation of their transactions and are advized by competent and experienced legal counsels.[55] According to *Cally Jordan*, echoing perhaps the idea of transnational law:

> [d]ifferent legal traditions demonstrate different levels of openness and receptivity to international norms which do not derive from state authority and are not subject to national judicial enforcement.[56]

The conventional argument is that the English legal system was recognized by the market participants as the most efficient, in terms of time, value and legal certainty and the rulings of the English courts are able to identify and apply transnational law, from customs to standard form contracts, in a receptive manner. To this end, it is possible that for a particular set of transactions, English courts have been receptive for a long time, which is perhaps illustrated by an early court case from 1759 in which it was stated that 'mercantile law is not the law of a particular country but the law of all nations.'[57]

In the OTC derivatives market, market participants often rely on and favour the expertise of courts and the legal certainty provided by their legal systems. This is also true in complex cases where courts apparently provide more legal certainty in comparison to other forms of dispute resolution.[58] The popularity of English law cannot explain why English courts would somehow directly apply and enforce market

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53 Muratori (n 18) also arguing that even Brexit is unlikely to have a significant impact on the popularity of English law, 95; Frank J Fabozzi, *Handbook of Finance, Vol 1 Financial Markets and Instruments* (Wiley Finance 2008) 282, summarizing the benefits consisting of low level of regulatory interference, well-established infrastructure, experienced human resources, and the use of English as the main language.

54 Jan Dalhuisen, *Dalhuisen on Transnational Comparative, Commercial, Financial and Trade Law, The Transnationalisation of Commercial and Financial Law and of Commercial, Financial and Investment Dispute Resolution. The New Lex Mercatoria and its Sources. Volume 1* (6th edition, Hart Publishing 2016) 189.

55 Mugasha (n 7) 560.

56 Cally Jordan, 'How international finance really works' (2013) 7 LFMR, 256, 260.

57 Luke v Lyde (1759) 97 Eng Rep 614, 618 (KB); 2 Burr 882, 887 (Lord Mansfield).

58 Frank Partnoy, 'ISDA, NASD, CFMA, and SDNY: The Four Horsemen of Derivatives Regulation' (2002) Brookings-Wharton Papers on Financial Services, 213, 214.

practices. To the contrary, they have a tendency of evaluating the relative bargaining power of the parties concerned over the contents of standardized contracts as well as the level of sophistication of the same.[59] The evidence would thus suggest that choosing English law to govern most contracts of international transactions can derive from historical reasons. The assumed ability of English courts to be able to consider market considerations better than their foreign counterparts, the accrued familiarity with a certain legal system and the English language, and even as a reinforcing 'snowball' effect where one argument favours the next argument, or in other words 'the very fact that English law is so widely accepted is in itself a factor of legal certainty'.[60] The dominance of English law continued as the governing law of eurobonds given at least the concentration of expertise accrued over time and the speediness of enforcement.[61]

Already in the early 1990s, *Ravi Tennekoon* summarized the three elements that market participants seek to control in international finance:

1. The validity, enforceability, and interpretation of all legal documents evidencing and constituting the transactions;
2. The legal rights and obligations of the various parties to an international financing transaction are identified; and
3. The extent to which other systems of law will affect the transaction.[62]

Effective enforcement is equal to the existence of a designated court of law or other dispute settlement body that: (i) can properly investigate the validity of the creditor's claim and a payment liability ordered on the debtor; and (ii) enforce the collection of debts, compulsorily or voluntarily. For an international transaction, it also requires that the judicial system identifies and acknowledges the other legal systems that affect the transaction besides the stated governing law of the contract as well as case-law of the English courts. From the ISDA MA perspective, this is especially relevant in regards to insolvency situations where the laws of the place of incorporation of the insolvent counterparty prevail over the governing law of the agreement.[63]

The findings made under *legal origins theory*, which focuses part of its analysis on the fundamental differences of common law and civil law countries, in turn has focused on explaining from an economic perspective:

59 ibid 213, 220.

60 Durand-Barthez (n 40) 514.

61 Tony Rhodes (ed), *Syndicated Lending – Practice and Documentation* (Euromoney Publications PLC, Playhouse Yard 1996) 311–12.

62 Ravi Tennekoon, *The Law & Regulation of International Finance* (Butterworths 1991) 16.

63 Harding (n 21) 220–21.

> [w]hy capital flowed so much more massively to New York and London than to Paris and Frankfurt. In what impressed many thoughtful economists as an interesting departure from the efficient market hypothesis, it focused on behavioral patterns and legal rules encouraging the provision of capital to financial markets.[64]

Three widely-cited articles by *Rafael La Porta* and others are briefly summarized here.[65] First, as demonstrated by La Porta and others, the character of legal rules and the quality of law enforcement, together with the legal environment of any given jurisdiction matters if the per capita GDP is used as an indicator of financial development. Second, the size and extent of a country's capital market and the willingness of investors to exchange funds for the securities of local companies' correlates with this indicator. The English-American common law jurisdictions fare better than the 'Napoleonic' French and the Roman-Germanic group when measured in terms of investor-friendliness and access to equity finance for local companies.[66] Lastly, the evidence suggests that for market participants, public authorities serve the purpose of facilitating the environment for private contracting. From the market perspective, the role of securities regulation may be limited to ensure transparency through disclosure requirements and in offering a platform, judiciary, for efficient private judicial remedies.[67]

The findings of La Porta and others have been widely cited and also cricitized regarding their methodology.[68] However, the findings of *Katharine Pistor* echo the findings of La Porta and others. In the context of the OECD countries, those countries referred to as 'liberal market economies', in which 'firms coordinate their activities primarily via hierarchies and competitive market arrangements' and where 'the equilibrium outcomes of firm behaviour are usually given by demand and supply conditions' are common law countries. In contrast, 'centrally coordinated' economies, i.e. 'economies in which firms depend more heavily on non-market relationships to coordinate their endeavours with other actors to construct their

64 Henrik Schmiegelow, 'A Counterintuitive Efficiency Divide between Common Law and Civil Law: Rules and Structures of Civil Procedure in Eight Developed or Newly Industrialized Countries' in Schmiegelow, Schmiegelow (n 45) 119.

65 Rafael La Porta, Florencio Lopez-deSilanes, Andrei Schleifer, 'The Economic Consequences of Legal Origins' (2008) 46 (2) Journal of Economic Literature, 62; Rafael Rafael La Porta, Florencio Lopez-deSilanes, Andrei Schleifer, 'What Works in Securities Laws?' (2006) 61 Journal of Finance 1; Rafael La Porta, Florencio Lopez-deSilanes, Andrei Schleifer, Robert W Vishny, 'Legal Determinants of External Finance' (1997) 52 (3) Journal of Finance 1131.

66 Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Schleifer, Rober W Vishny, 'Legal Determinants of External Finance' (1997) 52 (3) Journal of Finance 1131.

67 ibid (n 65, 2006) 19, 27.

68 Schmigelow in Schmigelow, Schmigelow (n 45) 124–28, noting, among other reasons, the general difficulty of assessing statistically a large group of countries, as well as 'generalizing association of civil law with government control of the business environment and inferior economic performance' 127.

core competencies' are in turn civil law countries.[69] In the European context, one reason for the popularity of English law as the governing law of contracts is the distinctive feature of the flexible property laws that it offers. According to *Elena Christine Zaccaria*, English property law has the 'ability to adapt and address market needs by frequently stretching and repositioning the boundaries of well-established principles rather than creating exceptions or novel concepts of law'.[70]

At least one study found that few English court cases involved ISDA MA prior to 2009. After the Global Financial Crisis, disputes increased considerably, suggesting that English courts were well positioned to affect transnational law, or 'to generate binding "fixes" for sophisticated contractual remedies, trigger public and productive debate about terms of standard form contracts, bind users and members, and develop 'market-minded' jurisprudence'.[71] As explained by *Agasha Mugasha*, the interaction between courts and trade organizations is that normally English courts and New York courts follow the industry practices in their interpretation and application of the law, and in the case of divergence between commercial perceptions of market participants and the courts, either the trade organization amends the standard documentation or legislative action is taken. As standardized financial contracts are so widely used, a court ruling may have global repercussions.[72]

In *forum shopping*, i.e. the strategic objective of seeking to have a case heard in the most favourable but not necessarily the most appropriate court, the question over which court to shop for may lean towards a choice between New York and English law.[73] Regarding the role of legislation, the most decisive indicator of the attitude of a legal system towards finance may also be found in its bankruptcy laws. As resources are scarce and not every creditor can get paid in full in the event of a debtor bankruptcy, the bankruptcy laws tell us who are favoured over the others and on what grounds, and whether the bankruptcy regime is geared towards being creditor or debtor friendly. In the latter, the regime aims to rehabilitate rather than liquidate insolvent entities. Creditors favour jurisdictions where their

69 Katharina Pistor, 'Legal Ground Rules in Coordinated and Liberal Market Economies' in Klaus J Hopt, ddy Wymeersch, Hideki Kanda, Harald Baum (eds), *Corporate Governance in Context: Corporations, States, and Markets in Europe, Japan, and the US* (OUP 2006) 249, 251, bringing forth suspicion towards the idea that legal rules are somehow converging across jurisdictions. Individualism or collectivism are deeply embedded in legal systems, 279.

70 Elena Christine Zaccaria, 'An inquiry into the meaning of possession and control over financial assets and the effects on third parties' (2017) J.C.L.S. 1, 3.

71 Joan Braithwaite, 'Standard Form Contracts as Transnational Law: Evidence from the Derivatives Market' (2012) 75 MLR 779, 803–04. For the discussion relating to the exclusivity of ISDA jurisdictional clauses, Christian Oetiker, Jana Essebier, 'Jurisdictional Clauses: Exclusive or Not? The Example of the English Courts' Jurisdiction under the 1992 ISDA Master Agreement' (2015) 9 No. 2 Disp. Resol. Int'l 149.

72 Mugasha (n 6) 560, discussing the interaction between courts and the ISDA MA, 561–74; Edward Murray, 'Firth Rixson: 'Section 2(a)(iii) of the ISDA Master Agreement' (2012) 25 Insolv. Int. 1, discussing the procedure of how the ISDA MA is amended once a court ruling concerning the same has the force of law.

73 Melanie Ryan, Andrew Yong, 'Springwell – are the English courts the venue of last resort for complex investor claims?' (2009) 24 J.I.B.L.R. 54.

rights are respected with the absence of minimum dividend requirements, where collateral arrangements are enforceable, and more generally, where property rights are respected and legal institutions are supportive of the rule of law.[74] Wood has summarized the core policies that should be observed if one is to enhance private commercial activity in any given jurisdiction: bankruptcy laws should be reasonably predictable, that are as simple as possible, are free of volatile governmental intrusion, that aim to reduce transaction costs, and respect towards contract and property rights nationally and internationally.[75]

The evidence suggests that not even a court ruling that rendered a whole range of OTC derivatives unenforceable would deter market participants to other competing financial hubs from London.

4.3.2 HAMMERSMITH AND FULHAM REVISITED

The new opportunities in the expanding OTC derivatives markets of the 1980s also attracted end-users unfamiliar to new products that led them to suffer great economic losses. This unfamiliarity and losses combined with legal uncertainties relating to the new products was also a driver for innovation from a new perspective in that it created incentives for lawyers, acting on behalf on the end-users as their clients, to find ways of seeking plausible ways of disputing the enforceability of the unfavourable trades and to recover damages from the dealers in courts.[76] Similar type of risks relating to unenforceability were already referred to as *legal risks* which could arise from lack of legal capacity or authority of the counterparty or, as discussed earlier, from bankruptcy or insolvency. It is not uncommon for courts to challenge and even deem unenforceable some type of obligations characteristic to OTC derivatives trading that can be hard to demonstrate. However, in the derivatives market the old risks manifested themselves in new forms especially as issues concerning the legal capacity and authority of the end-user, both corporate

74 Joel F Houston, Chen Lin, Yue Ma, 'Regulatory Arbitrage and International Bank Flows' (2012) Vol. LXVIII, The Journal of Finance, 5 1851, 1860, 1867, 1885–86, and in turn, generally the restrictiveness of financial regulation is positively associated with aggregated capital outflows, 1886.

75 Philip Wood, *Principles of International Insolvency* (2nd edition, Sweet and Maxwell 2007) 4–6; often this has not been the case, which is why standardized financial contracts, such as the ISDA MA, also need to be amended accordingly, Dermot Turing, 'Insolvency in Asian markets: lessons for the survivors' (1999) 1 J.I.F.M. 23. Generally, Ross Cranston, 'Theorizing Transnational Commercial Law' (2006–2007) 42 Tex. Int'l L.J. 597.

76 Denis M Forster, 'New Legal Weapons on the Derivative Battlefield' (1995) 14 Int'l Fin. L. Rev. 36, listing techniques as to how to render unfavourable transactions void and on how to recover damages as relating to missing capacity and authority (such as *ultra vires* and lack of individual authority to execute the trade(s)) and contract formation (such as requirement for contract to be in written form, absence of requisite contractual intent, inadmissibility of recordings of trade calls) and duress (such as misrepresentations by the dealer that subjected the end-user to economic duress) 37–38.

and non-corporate entities and their signatories, to enter into legally binding derivatives contracts.

The case *Hazell v Hammersmith and Fulham LBC* was a major ruling that added to the confusion of the enforceability of derivatives contracts due to acting beyond powers, i.e. *ultra vires*. The Council of the London Borough of Hammersmith and Fulham (Hammersmith), a very active end-user of swaps in the late 1980s, was found to have lacked the legal capacity and authority under the Local Government Acts of 1963 and 1972 to enter into these transactions and that all the swaps entered into by the same were speculative rather than to identify and manage financial risks of traditional lending. [77] Hammersmith had entered into a wide range of speculative trades with large exposures, according to some estimates over 100 times its annual turnover and had involved a wide array of different derivatives between 1987 and 1989. Already before running into financial trouble, it was an employee of a transnational financial institution who contacted state officials to warn about the status of Hammersmith. It was a deliberate legal strategy to seek a court order to declare the OTC derivatives transactions, that had turned highly unprofitable for Hammersmith, *ultra vires*.[78]

Once the case had gone through the Divisional Court and was appealed in the Court of Appeal, which had decided that swaps served a facilitative rather than a speculative function were legitimate, the U.K. House of Lords saw the situation differently and overturned the decision of the Court of Appeal.[79] The House of Lords asked whether the Council had had the legal capacity to enter into the swap transactions to begin with, which meant that the purpose of the swaps was not the legal question to be addressed. On these grounds, the swap transactions entered into by the Council, who apparently had failed to assess the suitability and the associated risks of derivatives and incurred heavy losses under the transactions, were found *ultra vires* due to lack of legal capacity of Hammersmith and Fulham, which would have required an express power in the relevant legislation.[80] This meant that not only these particular trades entered into by Hammersmith and Fulham, but also several thousand derivatives transactions entered into by around 130 local

77 Hazell v Hammersmith and Fulham LBC [1992] 2 AC 1.

78 Chris O'Malley, *Bonds Without Borders: A History of the Eurobond Market* (John Wiley & Sons, Inc 2014) 128.

79 ibid.

80 Martin Loughling, *Legality and Locality: The Role of Law in Central-local Government Relations* (Clarendon Press 1996) 349–50. While also welcomed, the ruling of the House of Lords attracted criticism. Building his argument on an official investigation report, Loughlin concludes, 361–62:

> [T]he Hammersmith experience provides some salutary lessons in the dangers of adopting an enterprise orientation [in a public authority] without proper safeguards or adequate scrutiny of its implications for the entire activities of the organization;

Brandon Becker, Francois-Ihor Mazur, 'Risk Management of Financial Derivative Products: Who's Responsible for What' (1995) 21 J. Corp. L. 177, 206–7, n 200, discussing a similar US court decision, 207–09.

authorities and over 80 banks, turned ultra vires and invalid.[81] [82] While the master agreement structure and legal opinions may have addressed issues pertaining to the legal capacity of the entity and the legal authority of the signatories, it became evident that it was not enough to protect the sell-side from claims based on an argument of the lack of legal capacity and authority and that further legal clarity as to the enforceability of derivatives transactions in this respect was in high demand.[83] The Hammersmith case did open up a string of other court litigations with similar *ultra vires* arguments that have been made until recent years, some successfully but more often unsuccessfully.[84]

4.4 THE REGULATORY ENVIRONMENT OF OTC DERIVATIVES IN THE 1980S

4.4.1 GENERAL OBSERVATIONS

There was virtually no law governing explicitly OTC derivatives trading in the 1970s and 1980s. This is why market participants had to often rely on *basic principles of contract*, or in the parlance of this research, fundamental principles of a transnational legal order discussed in subchapters 2.10.2 and 2.10.3. when constructing the legal structure of new types of transactions.[85] As there was no standard documentation in the market, financial institution drafted individually the terms and conditions of their derivative transactions on the basis of their existing lending documentation.[86] Nor was there regulatory control on swaps or clear recognition of the new products

81 Loughling (n 80) 355, describing also how market participants as well as local authorities who had successfully hedged against interest rate movements made an unsuccessful attempt for the implementation of retroactive legislation, with the support by the Bank of England, that would have rendered the transactions entered into between financial institutions and local authorities legal and enforceable.

82 Adam R Waldman, 'OTC Derivatives and Systemic Risk: Innovative Finance or the Dance into the Abyss' (1994) 43 Am. U.L. Rev. 1023, 1042–43. The same risk is persistent also in the current regulatory framework, Jo Braithwaite, David Murphy, 'Central Counterparties (CCPs) and the law of default management' (2017) 17(2), J.C.L.S. 291, 295–96, n 21.

83 David M Lynn, 'Enforceability of Over-the-Counter Financial Derivatives' (1994) 50 Bus. Law. 291, 308–09. Lynn also notes that legal opinions require further standardization as many of the legal opinions do not clearly state that the end-user has the capacity to enter into derivatives contracts, n 115. For similar US case law concerning capacity and authority issues, ibid 314–25. For the investor's responsibility in ensuring its capacity and authority, John McGrath, 'Derivatives under Global Scrutiny' (1994) 13 Int'l Fin. L. Rev. 20.

84 For a list and analysis of this case law, Ioannis Kokkoris, 'Liability of swaps dealers against users' (2006) 17 I.C.C.L.R. 63; Braithwaite, Murphy (n 82) n 21. For an analysis from a 'forum shopping' perspective, Ryan, Yong (n 73) 54.

85 Drew E Macintyre, 'Financial innovation and regulatory trepidation: swaps and the OSC' (1995) 25 CBLJ 163; Ronald L Cheng, 'Legal Doctrines Restricting the Secondary Market in Interest Rate Swaps' (1988) 26 Colum. J. Transnat'l L. 313, 314.

86 Schuyler K Henderson, 'Swap Credit Risk: A Multi-Perspective Analysis' (1988) 44 Bus. Law. 365, 385.

under tax laws.[87] In the US, derivatives could fall under existing financial regulations but the applicability of the existing regime was unclear as no case law or regulatory guidelines existed as to their applicability to new products previously unknown from a regulatory perspective. The legal uncertainty often led to disputes and litigation.[88]

In addition, even if the legal form and economic substance of a given derivative could be identified, it was often unclear which regulatory agency had control over which type of financial instruments.[89] The regulatory agencies themselves had been in dispute between themselves over jurisdictional lines already earlier[90] and now also in the new situation. At worst, official statements given by the regulators added to the confusion rather than reduced it. Importantly, many market participants chose to market and sell new products without waiting for a regulatory clearance, that might or might not be needed, but which was in any case unavailable from regulators. For some, it was already clear in 1986 that regulatory authorities will find themselves in a position where the market action would be difficult to reverse, because the markets simply will be too large and too well organized to permit regulatory intervention in the absence of a major confrontation between the industry and the regulators.[91] During the same era, '[a]s an exchange of cashflows, the swap structure could be used to replicate virtually any other kind of transaction'.[92] Traditionally, futures, a type of highly standardized derivative, were traded on regulated exchanges but the market had shifted to trading products bilaterally, or over-the-counter, which negatively affected the competitiveness of exchanges.[93] By the mid-1980s, new OTC derivatives products were being offered and traded 'by every major financial institution and multinational corporation in the world' at a speed that 'plainly has

87 Armell Cates, 'Swap Financing' (1986) 20 Int'l L. 837, 843; James A Watkins, 'Legal Issues in Currency Swaps' (1982) 1 Int'l Fin. L. Rev. 26, 31.

88 Stuart Somer, 'A Survey of Legal and Regulatory Issues Relevant to Interest Rate Swaps' (1992) 4 DePaul Bus. L.J. 385, 390, 395.

89 Daniel P Cunningham, Craig T Abruzzo, 'Regulating Derivative Securities and Transactions in the US' (1995) 14 Int'l Fin. L. Rev. 16, 17, discussing the uncertainty relating to the agency powers of The Commodity Futures Trading Commission, an US regulatory agency, that regulated at that time futures contracts and commodity options, and the Securities and Exchange Commission, that regulates the issuing and trading of securities; Chapter 5.

90 The earlier regulatory dispute in the early 1980s between the CFTC and SEC concerned the margining requirements both in the futures industry as well as in the OTC industry, Jerry W Markham, 'Federal Regulaton of Margin the Commodity Futures Industry – History and Theory' (1991) 64 Temple Law Review 59, 97–99.

91 David J Gilberg, 'Regulation of New Financial Instruments under the Federal Securities and Commodities Laws' (1986) 39 Vand. L. Rev. 1599, 1607–08, 1686–87.

92 Schuyler K Henderson, 'Derivatives law as a niche area is dead' (1997) 12 J.I.B.L. 351, 354–55; Bruce S Darringer, 'Swaps, Banks, and Capital: An Analysis of Swap Risks and a Critical Assessment of the Basel Accord's Treatment of Swaps' (1995) 16 U. Pa. J. Int'l Bus. L. 259, noting that 'almost any kind of swap can be created […] *Within these broad [swap] categories, infinite variations can be created*' 269–70 (emphasis added).

93 Macintyre (n 85) 163; Bank for International Settlements '62nd Annual Report' Basel, 1992, 15th June, 182 <https://www.bis.org/publ/arpdf/archive/ar1992_en.pdf> accessed 1 June 2019.

outstripped the ability of accountants, lawyers, and regulators to keep pace with their development and to determine their status under prevailing law and practices'.[94]

4.4.2 FUTURES? FORWARDS? – LET THE REGULATORS DECIDE

Forwards are traded, and cleared bilaterally, whereas futures are traded on exchanges and cleared by central counterparties. Whereas bilateral OTC derivatives trading allows for greater customatization of transactions contractually, central counterparty clearing facilitates several benefits in comparison to OTC derivatives trading.[95] In economic substance, these two products can be indistinguishable. Their actual difference has been debated at least since the 1980s, which renders the definitions context-bound. Financial regulation in the US states that 'futures contracts' are traded on exchanges and thus within the jurisdiction of Commodity Futures Trading Commission (CFTC), a US regulatory agency, whereas those which are not traded on exchanges but traded bilaterally, are not. The legal uncertainty as to what is a future and what is a forward has caused a significant amount of litigation.[96] In 1974, the futures industry became heavily regulated[97] and reregulated further in 1982 when the CFTC was granted with new enforcement powers, in a legislative process that was 'difficult, time consuming, and expensive'.[98] Futures refer here to products that are standardized to a degree where the counterparties negotiate only the future rate and the price of the transaction. All other terms and conditions are pre-set by an exchange in its rules leaving no room for counterparties to amend them. Futures in essence leave nothing more than the price of the product to be negotiated.[99] If the transaction involves further contractual customization that deviates from the pre-set terms and conditions set by an exchange, the product is a forward.[100]

In the US, the distinction between futures and forwards gave rise to legal risk. Trading in the former was a regulated activity whereas the regulatory status of

94 Gilberg (n 91) 39 Vand. L. Rev. 1599, 1600; for end-user perspective, Craig W Murray, 'The Oil and Gas Lawyer's Role in New Financing Techniques' (1995) 42 Ann. Inst. On Min. L. 44.

95 Jon Gregory, *Central Counterparties – Mandatory Clearing and Bilateral Margin Requirements for OTC Derivatives* (Wiley Finance 2014) 37.

96 Francesca Taylor, *Mastering Derivatives Markets: A Step-by-Step Guide to the Products, Applications and Risks* (4th edition, The Mastering Series, FT Press 2011) 24–25.

97 Stephen Greenberg, 'On Being Regulated: Remarks by a Futures Commission Merchant' (1977) 6 Hofstra L. Rev. 143.

98 Don L Horwitz, Jerry W Markham, 'Sunset on the Commodity Futures Trading Commssion: Scene II' (1983) 39 Bus. Law. 67, 82–84.

99 For an example of a multilateral clearing model which employs the ISDA MA architecture, Byungkwon Lim, Aaron J Levy, 'Contractual Framework for Cleared Derivatives: The Master Netting Agreement between a Clearing Customer Bank and a Central Counterparty' (2014) 10 Pratt's J. Bankr. L. 509, 512–14.

100 Roberta Romano, 'A Thumbnail Sketch of Derivative Securities and Their Regulation' (1996) 55 Md. L. Rev. 10–11.

forwards was unclear.[101] More precisely, it was unclear which government agency had the authority to regulate and supervise forwards. This risk arose from the Commodity Exchange Act (CEA).[102] Pursuant to the CEA, futures trading should be carried out in recognized exchanges meaning that trading in derivatives outside exchanges could be perceived as an illegal activity.[103] Historically tightly regulated by the CFTC,[104] which was facing competition from the OTC derivatives market, the futures industry was pressing regulatory agencies, namely the CFTC, to claim authority and to put forwards under the scope of futures regulation, but to no avail. To add to the confusion and legal uncertainty, any dispute over the same ending up in court could turn any existing interpretation to its backside. In addition to regulatory uncertainty, there was a significant risk of recharacterization were a court to reach another conclusion as to the economic and legal nature of forwards or futures.[105]

Complex definition disputes ensued over what is a ‘commodity’, ‘future’, and ‘future delivery’ under the CEA.[106] In turn, government regulation on swaps was ‘neither comprehensive or coordinated’.[107] The arguments from the swap market participants was that regulation would stifle innovation and drive business overseas, and the counterarguments were that left unregulated, there was not only a great risk of running into major defaults, but even cases of outright fraud.[108] In the late 1980s, the CFTC issued a no-action notice that would create a ‘safe harbor’ for some particular swap types but would otherwise leave the market wondering over the legal status and the enforceability of swaps.[109] Already at that time, the policy makers knew of the concentration and interconnectedness of markets and that a crash in one market may lead to crashes in other markets globally.[110] Following

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101 Kimberly D Krawiec, ‘More Than Just New Financial Bingo: A Risk-Based Approach to Understanding Derivatives’ (1997) 23 J. Corp. L. 1, 35–36. Some financial institutions had already adopted a view that forward trading was a part of their current activities and a permitted form of business. Jerry W Markham, David J Gilberg, ’Federal Regulation of Bank Activities in the Commodities Market’ (1984) 39 Bus. Law. 1719, 1769–70.

102 Commodity Exchange Act § 4(a), 7 U.S.C. § 6 (1982).

103 Marc A Horwitz, ‘Swaps Ahoy – Should Regulators Voyage into Unknown Water’ (1994) 1, Ind. J. Global Legal Stud. 515, 522–24.

104 Robert A Hudson, ‘Customer Protection in the Commodity Futures Market’ (1978) 58 B.U. L. Rev. 1, 8–12.

105 Horwitz (n 103) 545–49.

106 Mark D Young, William L Stein, ‘Swap Transactions under the Commodity Exchange Act: Is Congressional Action Needed’ (1988) 76 Geo. L. J. 1917, 1918–26.

107 ibid 1939.

108 ibid 1937–43.

109 ibid 1943–45.

110 Following the market crash in 1987, the US government set up a task force to investigate what had caused the market crash, The Report of the Presidential Task Force on Market Mechanisms, Department of the Treasury, (Jan. 8, 1988) 9–13 <https://archive.org/details/reportofpresiden01unit> accessed 1 June 2019; apparently, the whole crash was to a large extent caused by a problem in the IT trading infrastructure, llan W Kleidon, Robert E Whaley, ‘One Market? Stocks, Futures, and Options During October 1987’ (1992) 47(3) The Journal of Finance 851.

the enactment of the Futures Trading Practices Act of 1992,[111] the CFTC was given authority to exempt OTC products from the CEA. The CFTC did exercise this right and thus reduced the legal risk of OTC derivatives trading being seen as an illegal activity off-exchange futures trading under the CEA.[112] The CFTC was authorized to largely exempt all swaps transactions from public regulation and state law save for cases such as anti-fraud and anti-manipulation provisions on the condition that the exemptions were in the public interest. In its 1993 statement, the CFTC concluded that swap agreements are widely used by both the private and the public sector and that they are important tools for both hedging, risk management, and for the purposes of reaching ‘other financial objectives’. Enhancing legal certainty over enforceability of the OTC derivative products was seen as a public policy objective. The risk that these transactions would be unenforceable was to be reduced and financial innovation was to be promoted by not interfering.[113]

4.5 INTRODUCTION TO THE BASIC MECHANICS OF DERIVATIVES

4.5.1 DERIVATIVES CAN BE CONFUSING, BUT THEY DO NOT HAVE TO BE

The perceived complexity of derivatives can be seen as an overdone argument ‘driven more by fear than fact’ as ‘all complex derivative instruments are built from a combination of simple, seemingly safe, financial instruments’.[114] Transactions can be structured by using simple building blocks no longer than one page in their economic terms. From a legal perspective over-the-counter derivatives are not only bilateral contracts that contain rights and obligations but a technology in their own right to which ‘all of the laws, court decisions, and practices with respect to contracts in general should be presumed to apply [...] unless there is an identifiable reason not to do so [...]’.[115] Derivatives are bilateral contracts regardless of how they are traded or cleared.[116]

Derivatives consist of futures, forwards, options, and swaps - swaps are typically structured as a set of forwards - and their combinations to which almost only the creativity of their buyers and sellers set the limits. Market participants engage in

111 H.R.707.

112 John Andrew Lindholm, ‘Financial Innovation and Derivatives Regulation––Minimizing Swap Credit Risk Under Title V of the Futures Trading Practices Act of 1992’ (1994) Colum. Bus. L. Rev. 73, 90–93.

113 Swap Exemption 58 Fed Reg. 5587, 5590 (Jan 22, 1993).

114 Avinash Persaud, *Reinventing Financial Regulation – A Blueprint for Overcoming Systemic Risk* (Apress 2015) 144.

115 Schuyler K Henderson, *Henderson on Derivatives* (2nd edition, LexisNexis 2010) para 1.1.

116 Feder (n 15) 321–22; UNCITRAL, The Principles on the Operation of Close-out Netting Provisions, 27, 2013, ‘[t]he Principles also cover ‘central clearing’ mechanisms *which are ultimately also built on bilateral relationships*’ (emphasis added).

different strategies that employ a variety of market jargon products such as caps, floors, collars, swaptions, callable swaps, and overnight swaps, to name only a few, but they are built on the aforementioned basic structures.[117] 'OTC derivative' is an umbrella term that conveys no precise meaning other than it is a transaction that involves two counterparties who enter into and clear the transaction bilaterally. The OTC market of derivatives is 'everywhere and nowhere' as it affects every other financial market but has no fixed location and is not easily identifiable in comparison to other financial instruments. This is one reason why this market is perceived to be such a distant phenomenon.[118] Financial regulation remains local, whereas transnational banking is global. It may be impossible for local regulators to monitor the global activities of such financial institutions with any precision. [119]

In most, if not every, book and article on the subject, the author represents his own understanding of derivatives contracts as something that can be specifically identified, labelled, and analyzed. This research is no exception in this regard, but each example is written in the form of terms and conditions. This makes it easier to understand what structuring and contractual standardization actually mean.[120] One observation is that a 'derivative' is hard to define. *Schuyler Henderson*, while acknowledging the difficulty in defining the concept in a definite way, has summarized derivatives from a legal viewpoint as contracts for the '[e]xchange of cash or delivery flows between two parties, each of which flows is, in the eyes of the respective parties, equal to the other at the start of the agreement: a financial arrangement involving mutuality and valued by reference to current market rates, prices, or levels'.[121] *Alastair Hudson*, who notes the same difficulty, begins with the notion that 'derivative product is a financial product the value of which is derived from another financial product'.[122] The Bank for International Settlements defines derivatives as 'a financial contract whose value depends on the value of one or more underlying reference assets, rates, or indices, on a measure of economic value or on factual events'.[123] These or their close variations are the most common types of definitions but there are also others.[124] For the financial theorist, the categorization

117 Taylor (n 96) 127; David Loader, *Clearing and Settlement of Derivatives* (Butterworth–Heinemann 2005) 103–04.

118 Henderson (n 115) paras 1.1, 2.1.

119 Christian Hofmann, 'Global systemically important banks (GSIBs): operating globally, regulated nationally?' (2017) 2 J.B.L. 155, 157–58.

120 For a comprehensive overview, Romano (n 100); for practical examples, Flanagan (n 3) 215–20.

121 Henderson (n 115) para 1.1.

122 Hudson (n 35) para 1–06. Hudson refers to Henderson's earlier definition, ibid 25, n 6.

123 BIS, 'Glossary' 17 October 2016 < <https://www.bis.org/dcms/glossary/glossary.pdf?scope=CPMI&base=term> accessed 1 June 2019.

124 For other definitions and critical analysis, Timothy E Lynch, 'Derivatives: A Twenty-First Century Understanding' (2011) 43 Loyola University Chicago Law Journal 1; for a public policy proposal building on findings made in mandatory product approval outside finance, Saule T Omarova, 'License to deal: mandatory approval of complex financial products' (2012–2013) 90 Wash. U. L. Rev. 63; for a critical analysis of the derivatives industry, Hudson (n 35).

of different products may not always matter, but for a lawyer it does as the analysis of the *legal obligation* to perform differs between different types of products.

The following examples are so called 'vanilla' trades. In jargon, 'vanilla products' are those that are the easiest to trade and once the basic structure of such a product is customized, it becomes an 'exotic'. There is always demand for 'vanilla'. To use the vanilla analogy, if you change the type of onions used or cook them differently to a classic hamburger from a fast-food chain restaurant, it is no longer a trademark hamburger, but a hamburger that resembles the original hamburger: now there are assumedly less buyers in comparison to the standardized version. Or maybe not, and the new product ends up being in high demand among customers - no one can predict how a certain product will fare in a given market. The more tailored the product in terms of its substance, the more complex an exotic derivative product it becomes. Exotic products, in turn, have less buyers and sellers which means that their liquidity can be low.[125]

4.5.2 FUTURES AND FORWARDS IN CONTRACTUAL TERMS

Futures and forwards are promises to supply an asset, for example, a particular commodity or a security *at a set price on a set date*. Both parties are under legal obligation to perform their obligations regardless of, for example, the price fluctuations of the particular asset during the life of the contract. Both counterparties take a risk and although there will be a 'winner' and a 'loser' under the particular transaction, both have been able to knowingly protect themselves from a certain risk. This is one type of hedging which generally refers to strategic risk management against market movements.[126] Forwards and futures are often used in foreign exchange (FX) trading which allows contracting parties to 'lock in', i.e. agree on a future exchange rate for two currencies in advance. On the specific future date, the delivery can be either 'physical settlement', i.e. that on the agreed later date the contracting parties actually exchange the amount currencies at the foreign exchange rate agreed by the parties or more often by 'cash settlement', whereby only the difference between the agreed foreign exchange rate and the official exchange rate is paid by one party to the other for the amount agreed to by the parties. [127]

Simplicity means easy standardization and a high level of standardization makes products more liquid as there are many buyers and sellers for such products. These

125 Penny Davenport, 'Benchmarking in the OTC Derivatives Markets' in Taylor (n 96) 151–52.

126 Edward Murray, 'Derivative Transactions' in Paterson, Zakrzewski (n 32) 606–07.

127 Juan Ramirez, *Accounting for Derivatives – Advanced Hedging under IFRS 9* (2nd edition, Wiley Finance Series 2015) 97–99.

combined, standardized products can be traded in exchanges 'on-the-counter'.[128] In economic terms, the terms of a future or a forward contract could be and often are so simple to include:

- the counterparties;
- the trade date;
- maturity, i.e. the date on which the transaction is settled;
- the buy amount (Currency/Commodity X);
- the sell amount (Currency/Commodity Y);
- the forward/future rate (ie the exchange rate on the settlement date); and
- the settlement method (physical or, as in the vast majority of FX trades, cash).[129]

4.5.3 OPTION IS A LEGAL RIGHT TO ACT OR NOT TO ACT

Unlike forwards and futures, options do not oblige, hence the word 'option' to act or not to act, the option buyer to buy or sell the commodity, security or other asset (the right to buy is a *call option* and the right to sell is a *put option*) on a set date at a set price. For this, the option buyer pays a premium for the option seller. In jargon, the seller of the option is known as the 'writer' who is obliged to either sell or buy upon a notice of the option buyer.[130] Should the market movements become favourable to the buyer, it can use the option and if not, the buyer can simply choose not to use it. The risk inherent in options is that, unlike in forwards, where the future settlement amount is known (one agrees to buy and one agrees to sell a currency or a commodity at a set price at a set time) at the time of the execution of the transaction, the risk of the option seller can at least in theory be unlimited.[131] For example, an option seller could be legally obliged to deliver a particular commodity at the agreed price (known commonly as the 'strike price', i.e. 'the fixed price, per share or unit, at which an option conveys the righ to call (purchase) or put (sell) the underlying shares or units[132] to the option buyer regardless of the prevailing market price. The market price could be something much higher than the seller of the option had assumed.

A simple derivative contract could be as simple as follows:

128 Gregory (n 95) 16–17. In their modern form, futures trading began in 1972 as an added feature to spot foreign exchange contracts. Taylor (n 96) 205–07.

129 Ramirez (n 127) 97–8.

130 Hudson (n 35) paras 1–92–95; Loader (n 117) 201.

131 Taylor (n 96) 169; for a detailed account on the whole trading process, Loader (n 117) 83–96.

132 Loader (n 117) 199.

- Call option: the right and not the obligation to buy ('call');
- Exercise: conversion of the option into the underlying transaction or commodity, for example 100 shares of company X;
- Strike price: the price at which the option buyer can exercise the option;
- Expiry date of the option, i.e. the timeframe when the option buyer can exercise the option (for European style option, certain exact date and for US style any time during the life of the option);
- Rollover date, i.e. the date(s) when the buyer can exercise the option; and
- Premium

Behind these capitalized letters, there are standardized definitions drafted either by trade organizations like ISDA or the market participants themselves in their own templates. In short, the option buyer pays a premium for the seller and the option gives the buyer alternatives as to when, whether, how much, and at what price would the option be used[133] Like futures, options can be contractually standardized to the degree that they are eligible for exchange trading. In turn, customization of the terms and conditions can render the product more exotic and thus less liquid and less suitable for exchange trading.[134]

4.5.4 CURRENCY SWAPS ERODED LOCAL EXCHANGE CONTROLS

Early swaps made in the late 1970s 'made national borders largely irrelevant to the flow of capital among industrialized countries.'[135] Swaps are typically categorized into interest rate, basis, currency, and currency basis, as well as equity and credit default types. Interest rate swaps form the bulk of all the OTC derivatives. In market parlance, futures and forwards are used to hedge short-term exposures (0–3 years) and swaps for longer exposures (from 3 years to decades). The longer the maturity, the higher the risk(s).[136] In the US, 'swap' is a general term that covers a multitude of different derivatives products[137] whereas in the EU, derivatives are 'financial instruments', 'swaps' are a subcategory of financial instruments, and while it is not

133 Loader (n 117) 162–63.

134 Loader (n 117) 56–57.

135 Henderson (n 115) para 5.1

136 Taylor (n 96) 74–76.

137 Commodity Exchange Act, 7 U.S.C. § la(47)(A)(i) (2012):

> A) In general Except as provided in subparagraph (B), the term "swap" means any agreement, contract, or transaction— that is a put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on the value, of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind […].

defined, it is still listed as a distinct category.[138] The basic idea of a swap can be explained in simple terms. Most often, swaps are legal obligations used to exchange some cash flow in one way or the other from one party to other(s) for a certain time period.[139] The purpose of the exchange depends on what the parties wish to achieve, meaning at least in theory that it is the imagination of the same that sets the limits for their structuring.[140] For example, one can combine a swap, which is typically a set of forwards, with an option structure. The result is a *swaption*. For example, a swaption could be an option to enter into a swap.[141]

The following example is based on a real swap arrangement. It might not be an overstatement to say that following this swap transaction, national barriers on capital movements more or less lost their meaning if not instantly then in any case within a few years. The first modern currency swap was apparently executed in 1981, when Salomon Brothers, a transnational financial institution, acted as a broker in a $210 million currency swap between IBM, a transnational corporation, and the World Bank, a public international organization, whereby IBM swapped its (devalued) Swiss francs and deutschemarks to (overvalued) US dollars held by the World Bank. For IBM, the devalued currencies were a problem, but not the overvalued US dollars as it had a lot of cash, and for the World Bank the swap allowed it to provide cheaper funding to developing countries as it would have been possible with the more expensive US dollars.[142] Later on currency swaps came to be one of the main drivers for the increasing growth of the eurobond market where the bond issuances were used to facilitate pre-agreed swap arrangements.[143] A more generic example may be drawn from this real transaction.

Party A, a transnational corporation, has access to currency 1 at a competitive price but not to currency 2 which is, for one reason or another, unavailable or is relatively costly to obtain for Party A. Party A needs currency 2 but not currency 1. Similarly, Party B has better access to currency 2 but not to currency 1. Party A and B both raise the loans (or bonds, as the case may be) in their respective cheaper

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138 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU OJ L 173, 12.6.2014, p. 349–496 (MiFID II) Annex 1, Section C, (4), Financial instruments:

Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, emission allowances or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash […].

139 Hudson (n 33) para 1–96.

140 Darringer (n 92) 269–70.

141 Loader (n 117) 98–102.

142 Russel J Funk, Daniel Hirschman, 'Derivatives and Deregulation: Financial Innovation and the Demise of Glass-Steagall' (2014) 59 Administrative Science Quarterly 669, 671; for the market growth of the interest and currency swap market between 1986–1991, BIS, Recent Developments in International Interbank Relations, Basel, October 1992, Appendix A, Table 6, 49–50 <https://www.bis.org/publ/ecsc02.pdf> accessed 1 June 2019.

143 Frank J Fabozzi, *Handbook of Finance, Vol 1 Financial Markets and Instruments* (Wiley Finance 2008) 283.

currencies from their domestic banks. Both Party A and Party B now have loans in a currency that they do not want. For this reason, Party A and Party B enter into a currency swap transaction between each other. Put simply, under the currency swap, both Party A and Party B continue to repay their respective loans to their respective banks but they exchange liabilities between each other. Effectively, the economic position is that Party B pays interest and principal payments of Party A and vice versa. Both parties are in a position as if they would have had access to the cheaper currency from the outset without ever having a 'real' access to it. Naturally, it takes a lot of calculational structuration and contractual tailoring for the swap to be economically mutually beneficial to both parties. Again, and like in interest rate swaps, it is the perceived comparative advantage the counterparties might be able to use to their mutual benefit through currency swaps. Should the swap be structured correctly, both Party A and Party B should be in a better position due to the currency swap. In contrast, options and futures in principle have a 'winner' and a 'loser' depending on the market movements.[144]

The economic and legal terms of a currency swap could be as follows:

• Maturity	5 years
• Parties	Party A and Party B
• GBP nominal	GBP 70 million
• EUR nominal	EUR 100 million
• Initial exchange	On start date, Party A receives the EUR nominal and pays the GBP nominal
• Party A pays	Euribor 12-month annually, actual/360 basis, on the EUR nominal
• Party A receives	GBP 5% annually
• Final exchange	On maturity date, Party A receives the GBP nominal and pays the EUR nominal to Party B

In its simplest, and most common, form a cross currency swap involves the following cash flows:

- An initial exchange of principal amounts;
- A string of interim interest payments. Periodically, one party pays a fixed (or floating) interest on one of the principal amounts while the other party pays

144 The comparative advantage theory is controversial and, in relation to currency swaps, has been subject to academic debate since at least 1992, Robert H Litzenberger 'Swaps: Plain and Fanciful' (1992) 47 The Journal of Finance 831; John Andrew Lindholm, 'Financial Innovation and Derivatives Regulation– Minimizing Swap Credit Risk Under Title V of the Futures Trading Practices Act of 1992' (1994) Colum. Bus. L. Rev. 73, 81–84.

a fixed (or floating) interest on the other principal amounts. The payments may be netted

- A final re-exchange of principal amounts.[145]

The difference between interest rate swap and currency swap is that the latter involves more than one currency and usually includes the exchange of principals. The interest rate element in currency swaps can be fixed to fixed, fixed to floating, or floating to floating rate.[146] While derivatives can be made complex, drafting an agreement that would render local exchange controls, prohibiting borrowing from abroad, meaningless, is half a page long.

4.6 INSIDE A TRANSNATIONAL FINANCIAL INSTITUTION

There is a somewhat identifiable generic division of labour between the experts involved in financial transactions entered into by a financial institution. It is not a new argument that internal management matters and incentives in financial institutions may create risks on a systemic scale:

> [T]here may be incentives for at least some bank employees to engage in a variety of ploys that would lead to banker information failures. A person engaged in derivatives operations may emphasize rewards and downplay risks.[147]

First, there are the *researcher analysts* who analyze specific markets, individual entities or asset classes to produce information which can be used by the clients of a financial institutions usually for a fee.[148] Second, the financial instruments and products need to be priced and this is often the area of *quantitative analysts* and

145 The example is a simplified version of the example used in Ramirez (n 127) 102–03.

146 Taylor (n 96) 197.

147 Henry T Hu, 'Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism' (1993) 102 (6) Yale Law Journal, 1457, 1492–94, noting also the public safety net of financial institutions, bail-outs, and that prohibition on OTC derivatives should be weighted against their benefits and how a prohibition should be:

'justified only by compelling empirical evidence demonstrating that the social costs outweighed the social benefits. No such empirical evidence exists. Given the nascent understanding of the economics of the instruments, this empirical issue will not soon be resolved' 1495–96;

for a contemporary analysis of misconduct in financial institutions, Andrea Minto, 'Misconduct in Banks: Approaching the Issue from a Systemic Perspective' (2016) 31 J.I.B.L.R. 94, noting in regard to compensation schemes that '[m]anagers with unfettered powers (i.e. no regulatory constraints on behaviour) will tend to favour high-risk strategies, which have high variances and low or negative expected returns'.; Chapter 3 (n 217).

148 Terri Duhon, *How the Trading Floor Really Works* (Bloomberg Press 2012) 213–229.

deal structurers who create, calculate, and deploy different pricing models and risk management tools depending on the context.[149] The complexity of the models and technological advances are seen as one driver for general complexity in the financial system.[150] Third, the financial product can be sold by the sales expert to an individual client. At this stage, the division of labour can further be divided between the somewhat fractioned relationship and even cultural clash between *sales persons*, who manage client relationships and attend to the needs of individual client, and *traders*, who execute the transaction at a price which is also profitable for the bank as the seller of the financial product to the client, and, depending on the compensation scheme, maybe for the trader as well. In simple terms, the trader makes the market of the client (market maker) and the client either sells or buys on the bid or the offer of the trader (market taker).[151]

The experts of *middle and back office* ensure that the transaction is correctly carried out and booked in to the system of the financial institution. Fourth, *compliance officers* are responsible that their respective institutions comply with the internal and external regulations, laws, codes of conduct and standards, and perform risk assessment of the organization. This risk assessment often follows the risk analysis of public regulators meaning that the private analysis carried out by compliance officers also concentrates on the risks regarding financial stability and systemic risk implications.[152] Fifth, *risk managers* seek to ensure that there are processes in place for new financial product approvals and limits on various types of risk whether that is risk limits on individual traders, for example on the total notional amount the trader may have in its trading book, or the type of counterparties the trader may trade with.[153]

Lastly, there is the *legal team* or teams responsible that the contractual arrangements are in place and individual terms and conditions are negotiated with each counterparty and that the transactions comply with both external and internal compliance requirements. There is a further division of labour and specialization involved in handling these two aspects and in some types of transactions expertise

149 ibid 252, 266.

150 Dan Awrey, 'Complexity, Innovation, and the Regulation of Modern Financial Markets' (2012) 2 Harv. Bus. L. Rev. 235, 246–50.

151 Duhon (n 148) 84, 192; Traders learn their skillset in one financial institution, and if they want to learn more, they typically switch to the 'buy-side' bringing with them the culture they became accustomed to and the personal connections they made at their earlier employer, Ilya Beylin, 'A reassessment of the clearing mandate: how the clearing mandate affects swap trading behavior and the consequences for systemic risk' (2015–2016) 68 Rutgers U.L. Rev. 1143 1178, 1185.

152 This is an example of regulatory convergence between public and private, Geoffrey P Miller, 'Risk Management and Compliance in Banks' in Danny Busch, Guido Ferrarini (eds), *European Banking Union* (OUP 2015) 210–16.

153 Duhon (n 148) 298–308, noting also that risk management cannot and should not be considered to be a function of a particular group, but a responsibility of every expert involved in the transaction(s), 298–99.

is required in both.[154] As noted by Hu, lawyers 'involved in financial innovations [...] must be sensitive to less obviously relevant bodies of law which *can materially affect the economics* of new financial products'[155] and Edwards:

> [A]s derivatives do not conveniently fit within a particular area of law, derivatives lawyers are required to apply contract, company, commercial, property, insurance, and corporate insolvency law to the business of derivatives whilst being concurrently aware of accounting, tax, credit, and regulatory implications.[156]

4.7 SELF-REGULATION THROUGH CONTRACT

4.7.1 FINANCIAL ENGINEERING BEFORE SWAPS: BACK-TO-BACK LOANS

Hedging is essentially a method which is designed to mitigate different types of risks in a financial transaction.[157] In one simple example, if one has ever been worried that the interest rate might go up on a mortgage, buying an interest rate cap (that limits the interest rate to a preagreed level regardless of the actual interest rate level) from a financial institution is one way to hedge against the risk of rising interest rates.

To contextualize early de- and reregulatory policies, one significant change during the 1970s and 1980s was the deregulation of the restrictions on the ownership in stock-brokerage firms and of the restrictions which services providers can offer lead to foreign ownership and the emergence of new types of financial services.[158] For example, the re-regulatory approach in the UK to market regulation focused on functions rather than form of business or the ownership structure. For market participants, this approach did offer freedoms of not being bound by national legislation, at least not to the same extent as elsewhere during the 1970s and 1980s, and an opportunity for market participants to 'affiliate themselves to one or several transnational professional bodies, according to the business carried on'.[159]

154 The required expertise follows the introduction of the new public financial regulation that began emerging in the 1990s, Ross Cranston, 'Banking and Investment Services: Implications of the New Financial Landscape' in Guido Ferrarini, *European Securities Markets – The Investment Services Directive and Beyond* (Kluwer Law International 1998) 45–46.

155 Henry TC Hu, 'Swaps, the Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm' (1989) 138 U. Pa. L. Rev. 333, 341, n 22 (emphasis added).

156 Steven Edwards, 'Legal principles of derivatives' (2002) Journal of Business Law 1.

157 Loader (n 117) 185.

158 Peter JR Bloxham, 'The Financial Services Act' (1986) 1 I.B.L.J. 73, 74.

159 Eddy Wymeersch, 'The Implementation of the ISD and CAD in national legal systems', 9, in Guido Ferrarini (ed), *European Securities Markets – The Investment Services Directive and Beyond* (Kluwer Law International 1998).

As described by Watkins, the abolition of local exchange controls on international capital flows was a significant change in 1978, after which obstacles for import and export of cash and securities were removed. This meant that obligatory permissions from state treasuries and the requirement to make foreign currency investments at a higher exchange rate and to return a certain amount of the foreign currency upon the realization of their foreign investment were no longer relevant.[160] It was already a common practice to bypass the restrictions through financial and legal innovations, however, such as *back-to-back loans*, with the explicit or implicit permission or unawareness of regulators.

There was also the issue of *reregulation* of virtually all known financial entities that were made subject to new regulatory requirements by their functions following some deregulations in other areas.[161] Different types of exchanges vary greatly in their governance structures, which reflects their rulebooks, an evidence of spontaneous norm creation and normativity in itself, on how trade is conducted. Often the rules of an exchange are a combination and interplay of government regulation and self-regulation. As late as the 1980s most exchanges were privately regulated and owned by their constituencies, whereas today they are subject to public regulation and are often publicly traded corporations instead owned by their founders.[162]

Going back from exchanges and regulatory changes to the simple act of borrowing abroad, exchange controls prohibiting this activity in the UK were a driver for financial innovation in the lending market.[163] Already before 1979 when the exchange controls were still in force, structuring allowed market participants to avoid their applicability to their transactions. In the lending market, back-to-back loan arrangements opened up not only access to foreign lending markets, but also at a cheaper rate, simultaneously allowing for price arbitrage and the hedging of rate fluctuations.[164] Swap structures were an evolutionary step forward from back-to-back loans in that they allowed market participants to lower their credit risk as the former reduced the amount of funds the market participants had to transfer between each other.[165] The ability to shield from the latter was in high-demand given that especially the latter-half of the 1970s was a time of great price volatility across different markets and financial instruments from which market participants sought

160 Watkins (n 87) 26.

161 For a general UK perspective on why some areas were deregulated and reregulated, David Walker, 'Some Reflections on Big Bangs in Financial Systems' (1987) 13 CBLJ 388.

162 Thierry Foucault, Ailsa Röell, Marco Pagano, *Market Liquidity: Theory, Evidence, and Policy* (OUP 2013) 32–34.

163 Watkins (n 87) 26–27.

164 Watkins (n 87) 26.

165 Patricia Brown, 'Tax Consequences of Interest Rate Swaps: Characterization by Function, Not Prejudice' (1988) 6 Int'l Tax & Bus. Law. 122, 133–35.

to shield themselves.[166] The change from fixed to floating exchange rates meant that market participants became vulnerable to outside shocks against which they had to protect themselves through fixed/float diversification.[167] It was not the state that brought this common legal structure to its end, but an English court decision that gave rise to legal uncertainty that in turn forced market participants to seek alternative methods to back-to-back loans. Following the *British Eagle* decision,[168] the legal structure of back-to-back loans was becoming exceedingly complex and risky from a legal standpoint regarding their enforceability.[169]

By the end of the 1970s, swap structure took over the back-to-back loans. Swaps were structured into a form that did not constitute borrowings from a legal perspective and thus were not subject to exchange controls. For financial purposes, they were borrowings.[170] Back-to-back contracts gave rise to legal uncertainty as it was unclear whether a non-defaulting debtor could terminate its obligation to repay even if the counterparty in the arrangement was in default.[171] In principle, the non-defaulting party could set-off its claims against the defaulting counterparty. However, following the *British Eagle*, the legal structure of back-to-back loans was becoming exceedingly complex and risky.[172]

In comparison, swaps were easier than back-to-back loans to terminate upon counterparty default. The latter constituted outstanding debt in comparison to swaps that the non-defaulting could terminate as unknown future obligations. The non-defaulting party of a swap was contractually entitled to accelerate, i.e. make payments due immediately, following a default notice to the defaulting party. The enforceability of such contractual term under back-to-back loan contracts had become legally uncertain.[173] Back-to-back loans had already opened up access to foreign capital markets and even at a cheaper rate than would otherwise been possible, allowed for hedging of interest rate fluctuations, and could be even used to avoid exchange controls from being applicable, at least to some extent.[174]

166 Stefan Gerlach, Srichander Ramaswamy, Michela Scatigna, '150 years of financial market volatility' BIS Quarterly Review, September 2006, 80–1 <https://ssrn.com/abstract=1632414> accessed 1 June 2019.

167 Gautam Goswami, Milind M Shrikhande, 'Interest Rate Swaps and Economic Exposure' (1998) 9 Global Finance Journal 51.

168 British Eagle International Air Lines Ltd. v. Campagnie Nationale Air France, 1975 1W.L.R. 758.

169 Watkins (n 87) 26.

170 Cates (n 87) 837–38.

171 Watkins (n 87) 30.

172 Watkins (n 87) 26.

173 Watkins (n 87) 30, also noting how '[s]ome draftsmen have attempted to steer a course around this problem by expressly making the obligation to repay back-to-back loan a conditional obligation'.

174 Watkins (n 87) 26.

4.7.2 PRIVATE NORMATIVITY AT PLAY: CONTRACT STANDARDIZATION

Contract standardization makes trading across markets easier, it lowers transaction costs, and standardized contracts, or customary standard terms, are overall more convenient to use standardized contracts, in transactions than to draft them individually.[175] *Marcel Kahan* and *Michael Klausner* describes the *learning benefits* of standardized contracts in more detail. It is more efficient as there are probably less errors in contracts examined by many professionals than in individually drafted contracts. The other side of the argument is that once standardized to a high degree, no learning occurs if no one bothers to read the standardized contracts any longer for the same reason. [176] An associated problem is the compartmentalization of knowledge, which is especially relevant for modular agreements such as the ISDA MA, thus very few may have a view of the whole contractual arrangement; mistakes in drafting may become multiplied across transactions under the same contractual architecture.[177] If a standardized term has been evaluated by a court, it can further add to legal certainty if, for example, the court ruling sets a judicial precedent regarding how certain standardized terms or even individual words are to be construed.[178] Network benefits also apply, meaning that the more a standardized contract has users, the more beneficial its use becomes, as well as switching costs, meaning the more familiar the users are for a specific type of a standardized contract, the likelier it is that such users wont switch to a competitor's standardized contract, even if the latter is technically superior. [179]

Contract standardization does not protect from all types of risks. As said, standard documents do not offer solutions if the market participants fail to follow its terms and conditions. Second, the standardized documentation, while reducing transaction costs, can evolve from a relatively simple architecture into an increasingly complex architecture that gives rise to legal disputes in itself. Third, the unfamiliarity of courts with the documentation and the market in general can give rise to legal risk. Courts may find standardized market contracts to be illegal or unenforceable, or otherwise draw conclusions from the perspective of the market that may be questionable. Depending on the case, a court ruling in one country may have negative

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175 Anna Gelpern, 'The Importance of Being Standard' (January 2017) European Central Bank 2016 Annual Legal Department Conference Proceedings 23, 25–8,

<http://scholarship.law.georgetown.edu/facpub/1971 or https://ssrn.com/abstract=2963333> accessed 1 June 2019.

176 Marcel Kahan, Michael Klausner, 'Standardisation and Innovation in Corporate Contracting (Or the Economics of Boilerplate)' (1997) 83 Va. L. Rev. 713, 720–21.

177 Anna Gelpern, 'Commentary: Public Promises and Organizational Agendas' (2009) 51 Arizona Law Review 57, 71 <http://www.arizonalawreview.org/pdf/51-1/51arizlrev57.pdf> accessed 1 June 2019.

178 Kahan, Klausner (n 176) 722–23.

179 ibid 725–28.

repercussions on the whole market that the market participants will then seek to address by amending the standard contract as may be required.[180]

Through standardization, transaction lawyers have developed a common language. Importantly, the language used by those engaging in finance is not limited to certain area of finance but is usable across multiple types of financing. The usual structure of a transaction has involved and continues to involve the same questions: Are the pledges that secure the loan enforceable should the borrower be unable to repay the loan?[181] If the debtor has several creditors, what is the priority of multiple claims, i.e. who gets the interest payments first and in what order? Which party gets paid first if the debtor becomes bankrupt?[182] How will a local court interpret a certain standardized clause considering its national legal system?[183] These questions touch upon local property laws, contractual techniques, and bankruptcy laws, or more generally, to bodies of laws that may materially affect the economics of a transaction. The issue of asset separation, client assets separated from own assets, i.e. the issue of commingling where the holder loses proprietary interest, what could constitute preferential or even fraudulent transfers, tax issues, and finally enforcement rights, i.e. the right of a contracting party to enforce its rights in a court, both domestic or foreign, are also central for virtually any type of financing. The relevant legal issues are very much the same across jurisdictions.[184]

There is nothing inherently new in that lawyers draft the contractual architecture and individual terms and conditions, that may be required for a certain transaction, and that the same set of standardized terms and conditions is then used as the base for transactions by others.[185] Standardized contractual terms and conditions evolve in that they reflect accumulated experience. Standardization has long been considered a form of 'private self-government' and the content of standardized contracts as something that courts should pay special attention to.[186] Development

180 Schuyler Henderson, 'Credit derivatives and operational risk, or why a credit default swap is not like a bond' (2007) 1 Law & Fin. Mkt. Rev. 31, 32–33, 35.

181 Joshua Margolis, Chul Hyun Kim, 'Court Ruling Leaves Uncertainty over Secured Lending' (2003) 22 Int'l Fin. L. Rev. 25, discussing a ruling of the Korean Supreme Court 'that casts doubt over the enforceability of pledges as security in the context of corporate reorganizations'.

182 Steven L Schwartz, 'The Universal Language of Cross-Border Finance' (1998) 8 Duke J. Comp. & Int'l L. 235, 236, 239–43.

183 Helmut Merkel, 'Implications of the negative pledge clause in international finance' (1987) I.B.L.J. 669.

184 Schwartz (n 182) 244–46. Schwartz concludes his simple main point '[r]etain local counsel with top expertise, know how to ask the relevant questions, and be sure counsel fully understands both the questions and their underlying rationale', 254; for an example of relevant legal questions in securitization, Krebzs (n 31) 59–61.

185 For innovation and standardization in the lending markets as a response to fluctuations in rates in the late 1970s and early 1980s, Duane D Wall, Sean J Geary, 'Interest Rate Options, Funding Practices and Yield Protection' (1982) 1 Int'l Fin. L. Rev. 20.

186 Karl N Llewellyn, 'Common Law Tradition: Deciding Appeals' (1960) 256, 362:

> The content of the standardized terms accumulates experience, it avoids or reduces legal risks and also confers all kinds of operating leeways and advantages, all without need of either consulting counsel from instance to instance or of bargaining with the other parties;

and enforcement of private standards and rules generally, and the standardization of contractual terms, have also formed a part of central clearing from its modern beginnings. For example, as early as the 19th century, market participants could hedge risks of price changes through typifying the commodities that could serve as the underlying of futures contracts and the standardization of the delivery terms, including offsetting claims. Contractual standardization was a method to enhance liquidity through making different types of contracts fungible, i.e. as something more easily comparable and thus more tradeable.[187]

For example, in the lending markets that had proliferated at the end of the 1960s following the emergence of the eurodollar market, the syndication process was quite similar as it is today: each member of the syndicate makes a separate loan to the borrower, one of the syndicate banks is chosen as the agent through which payments and communications will be channelled, the syndicate delegates some of their powers to majority control, and the payments of the debtor are shared on a pro-rata basis. The overall contractual architecture and its foundations have not changed and the refinements to or the introduction of new terms and conditions often reflect unexpected events of the past. In short, the terms and conditions included conditions precedents, i.e. the conditions that had to be met before the banks were obliged to lend, terms allowing the borrower to prepay the loan but only in accordance with some conditions, the interest rate of the loan was a certain margin over LIBOR, and the interest periods could be chosen by the borrower. In addition, they included common clauses for taxes, increased costs, illegality, standard representations and warranties, events of default and acceleration, and so on, which are all part of standardized syndicated credit documentation.[188] There was much standardized contractual language from which to build upon new contractual architecture, but OTC derivatives were in many ways very different from lending.

Georges GR Delaume, *Law and practice of transnational contracts* (Oceana Publications, Inc. 1988) 100:

> Operating in substantially the same environment, new organizations tend to naturally benefit from the experience acquired by older organizations and exchanges of information, including contracts with their respective borrowers, among them is frequent […] definite patterns of lending have emerged and find their expression in the carefully drafted and detailed agreements prepared by these institutions.

187 Randall S Kroszner, 'Can the Financial Markets Privately Regulate Risk? The Development of Derivatives Clearinghouses and Recent Over-the-Counter Innovations, Part 2: The Role of Central Banks in Money and Payments Systems' (1999) 31 Journal of Money, Credit and Banking 596, 600; Default management is a complex part of an already complex industry and in many respects, financial regulation in itself can contribute to legal risks, Braithwaite, Murphy (n 82) 291.

188 Wood (n 32).

4.7.3 THE REGULATORY FRAMEWORK AND THE EVOLUTION OF SWAPS

Swaps were starting to take shape as essentially a long-term, non-transferable credit risk. In the mid-1980s, market participants soon discovered that freely transferable swap transactions would run into practical, legal, and regulatory challenges. The non-transferability of swaps was borne out of practical need as well as legal and regulatory considerations. These challenges directed market participants to structure swaps as non-transferable which in time became contractually standardized. First, free transferability could mean that a swap transaction could be recharacterized as a security by regulators which would mean the applicability of existing financial regulation concerning securities also to swaps transactions.[189] Swap contracts are transferable at the permission of the counterparty as are other types of contracts. However, the transfer could lead to undesired outcomes also under tax regulations. The transfer could have meant an instant tax liability for the party 'in-the money' under the swap transferred. It could be argued that the tax consequence would essentially go against the ratio of the swap as a means of dispersing risk for a period of time. [190]

The alternative to transfer was to assign the swap to a third party but this would also require the consent of the counterparty which might be unwilling to do so. Further, under the laws of many jurisdictions, a party cannot unilaterally transfer its obligations without novating it to a third-party which would again need the consent from the original counterparty. Even with consent, the transferer would retain a contingent liability towards the original counterparty if the transferee would not perform its obligations. The solution was to not transfer but to figure out a practical solution. The solution was to leave the original swap in place and enter into a 'mirror' swap, a reverse swap of the original swap. This would give the party the benefit of the original swap. In turn, however, the mirror transaction would mean that a new transaction would have to be negotiated, and there would be two sets of cash flows requiring monitoring as well as doubled credit risk since there was now two counterparties instead of one.[191] However, when weighting the above considerations against the increase in counterparties, the latter alternative became the market standard way of doing business in the OTC derivatives markets.[192] While the adoption of the ISDA MA architecture made trading with swaps easier, standardization came with a recharacterization risk. Whilst enjoying an exemption from an exchange trading requirement to which futures trading was subject to

189 Henderson (n 115) para 17.28.

190 Cates (n 87) 842–43, n 5; Henderson (n 115) 908–09.

191 Cates (n 87) 843; Mark D Young, William L Stein, 'Swap Transactions under the Commodity Exchange Act: Is Congressional Action Needed' (1988) 76 Geo. L. J. 1917, 1934-35.

192 Under the standardized ISDA MA architecture, the assumption is that the parties may not transfer the agreement or any interest or obligation in or under the same. Henderson (n 115) 17.28.

under the Commodity Exchange Act, swaps, consisting of forward-rate transactions could become recharacterized as futures.[193] Regardless of this risk, the incentives to engage in this business started to accumulate. The larger the swap market, the more there was liquidity, and the more liquid a product became, the more there was incentive to standardize such products. Market participants argued that swaps were not futures, but there were many counterarguments for claiming otherwise. There was an identifiable risk that if regulated, swap markets could move elsewhere.[194]

> *Mirror swap* Party B has sold an interest rate cap to Party A. Under the terms and conditions of the interest rate cap, Party B has a legal obligation to pay to Party A if the interest rate reaches 5 per cent. For whatever reason, Party B no longer wishes to hold such market position. Accordingly, Party B could ask for a permission from Party A to assign the legal obligation to a third-party Party C. Should Party C not perform its obligations towards Party A, Party B still has a contingent, a secondary liability that is, to perform even if the legal obligation had been transferred. This secondary liability is a legal risk that could not be easily controlled by Party B. Alternatively, Party B can enter into a mirror interest rate cap with Party C the terms and conditions of which would be as follows:

Buyer	Party A (protection buyer)
Seller	Party C (protection seller)
Maturity	10 years (15 January 2027)
Notional	EUR 500,000
Cap rate	5%
Underlying	Euribor 12-month
Rollover date	2 days before the interest payment date
Premium	EUR 1000 paid up-front

> While Party A now holds two contracts instead of one, the position of Party A is now zero meaning that should the interest rate reach 5 per cent, Party A does not in principle lose anything as it is out-of-the-money under one contract and in-the-money under the other with identical terms. Naturally, however, having two counterparties equals two counterparty risks. While derivatives can mitigate risks, they transform or convert risk rather than makes it disappear. In this example, the transformation concerns the transformation of *a market risk* to a *credit risk*.[195]

193 Subchapter 4.4.2.

194 Young, Stein (n 191) 1833–38, 1946–47.

195 Henderson (n 86) 398–400.

For transaction lawyers, the new way of doing business meant that they needed to have knowledge on traditional equity issuances, debt finance, and financial regulation, as well as the capability to draft the terms and conditions of new products. For investors, it meant a fundamental change in how trades were executed as derivatives trading necessitated immediate price quotes from the market, i.e. from those willing to swap the credit risk, how swaps needed to be valued on a daily mark-to-market basis internally, because of the market volatility which might necessitate entering into a new swap with another counterparty, and how the investments were managed now more as a portfolio, as swaps opened the market in wholly new ways, rather than as individual investments.[196] Such changes in business conduct and new types of business, in turn, needed to find articulation in new types of derivatives contracts as well as in existing loan documentation as many types of debt financing also started to include a separate but interlinked derivative transaction with its own contractual architecture.

4.7.4 THE EROSION OF THE GLASS-STEAGALL RESTRICTIONS

One important thing to note repeating is that formally repealing or otherwise disapplying an existing regulation is not necessarily the starting point for a new type of financial activity to emerge. Markets can form spontaneously even in a tightly regulated environment as described in Chapter 3. Findings made in economics may further illustrate this point. Market activity combined with financial and technological innovation can outgrow its regulatory framework to a point that renders the latter as simply obsolete dead letters where it makes little sense to keep the regulation in force but much sense simply to deregulate. Technological progress can lead to deregulation and simultaneously erode the benefits of regulatory barriers that inhibit competition and favour some market participants.[197] Bank deregulation followed by technological advancement can decrease income inequality, especially among the poor.[198] A prime example of the interaction between finance and law can be found in the repealing of the 'Glass Steagall restrictions', that refer to a set of US regulatory prohibitions enacted originally in the early 1930s.

In the wake of the Great Depression, the Glass-Steagall led to the separation of commercial banking and riskier securities business in the US. The Glass-Steagall was formally repealed in 1999 once it was already evident that '[c]hanges in the

196 Henderson (n 92) 351, 353.

197 Randall S Kroszner, Philip E Strahan, 'What Drives Deregulation? Economics and Politics of the Relaxation of Bank Branching Restrictions' (1999) The Quarterly Journal of Economics.

198 Thorsten Beck, Ross Levine, Alexey Levkov, 'Big Bad Banks? The Winners and Losers from Bank Deregulation in the United States' (2010) LXV 5, The Journal of Finance 1637.

actual business activities of financial firms substantially altered the effects of the law and catalyzed the process of deregulation'. The use of OTC derivatives, especially swaps, was elemental in this evolutionary process.[199] The Glass-Steagall had a 'loophole' which commercial banks could use to engage in de facto investment banking business.[200] Official removal of the Glass-Steagall restrictions was more of a formality. In the US, deregulation of intrastate branching and interstate banking, as well as multibank holding companies started in the 1970s and was generally more characteristic of the mid-1980s.[201] The evolutionary processes are in constant motion and transnationalisation of law began much earlier than any formal act of deregulation by states.[202]

By the late 1970s, and early 1980s, it had become very common for sovereign and corporate issuers to use swaps to benefit from comparative advantages different market participants had in different markets. They were long term because often their underlying asset, loans and bonds, had typically a long maturity spanning from a few years to decades. Often the economic rationale of the eurobond issue was not to raise capital for themselves, but to use the proceeds of the issue to access other financial markets to which they lacked direct access, or they had access but with relatively unattractive terms.[203] This was achieved by using swaps which effectively meant the creation of an interlinkage between swaps (bilateral OTC transactions), securities (especially eurobonds), and bank lending.

Swaps changed the whole landscape of banking in the 1980s in that, depending on the transaction, they could be structured as something resembling loans, securities, or futures, without necessarily being legally characterized as none of them. Retail (or commercial) banks had two functions, deposit taking and lending. Investment banks engaged in investment advice, intermediation, and trading for their own account with their own assets. They were regulated as separate types of business under the

199 Funk, Hirschman (n 142) 673; The Glass-Steagal Act was a popular name for certain parts of the US Banking Act of 1933 which was originally demanded by an interest group to shield them from competition and to enjoy 'super-competitive returns'. Once new competitors entered the financial market uninhibited by the Glass-Steagal Act it favoured commercial and investment banks to lobby for its deregulation, Jonathan R Macey, 'The Myth of "Reregulation": The Interest Group Dynamics of Regulatory Change in the Financial Services Industry' (1988) 45 Wash. & LeeL. Rev. 1275 <https://scholarlycommons.law.wlu.edu/wlulr/vol45/iss4/4> accessed 1 June 2019.

200 Craig W Murray, 'The Oil and Gas Lawyer's Role in New Financing Techniques' (1995) 42 Ann. Inst. On Min. L. 44, 46-47.

201 Kroszner, Strahan (n 197) 1441.

202 In contrast, this evolutionary view does not necessarily resonate with the macroprudential view that apparently emphasizes formal acts deregulation, while acknowledging the nonexistence of regulation in some cases, as a driver for financial innovation that allegedly led to the global financial crisis of 2008. Xavier Freixas, Luc Laeven, José-Luis Peydró, *Systemic Risk, Crises, and Macroprudential Regulation* (MIT Press 2015) 94–98.

203 Josephine Carr, 'Eurobonds Know No Bounds' (1987) 6 Int'l Fin. L. Rev. 7, noting

> '[o]f the US$178bn worth of bonds issued last year almost two-thirds were swap driven compared to one third in 1985 the profit lying in the swap as pricing becomes tighter on the bond'.

Glass-Steagall Act, and from the 1980s, they were competing in new OTC derivatives markets that did not fall into existing regulatory categories.[204] Regulators who wished to regulate the new products had to either seek to apply existing regulations to the new business or seek new authority from legislature. In both cases, the regulators would be met with opposition from industry lobbyists as well as other regulators who would have chosen not to regulate.[205] Financial innovation and ambiguous products eroded the existing similarly ambiguous regulations and regulatory categories. The categorization between retail and investment banking remains a central topic in financial regulation.[206]

Havd things changed since the 1980s? Post-GFC in the US, a rule commonly referred to as the Volcker rule,[207] also known as 'Glass-Steagal lite', entered into force. Among other objectives, the Volcker rule seeks to limit contagion from the shadow banking sector to commercial banks, limit trading for their own account by commercial banks (proprietary trading), and prevent the possibility of public funds being allocated to the shadow banking sector indirectly through and by commercial banks.[208] The Volcker rule is said to contain regulatory 'loopholes' and that it will give rise to regulatory arbitrage opportunities as well as produce unintended and unknown consequences.[209] According to *Adam J Levitin*, with explicit and implicit government guarantee on the financial industry and financial regulation that stimulates product innovation and regulatory arbitrage, it is also the source of financial instability. The present state of banking is a combination of historical path dependence of fractional-reserve banking, and both the financial service industry's and the financial regulators' incentive to retain the status quo because it serves their respective interests.[210]

During the transformative decade of the 1980s, financial institutions switched from brokerage, with the idea of bringing together buyers and sellers for a fee, to dealing in their own account. This allowed them to charge fees on each of their own counterparties as well as to enter into transactions, or to take market positions, of their own. OTC derivatives products were not on-balance-sheet but were rather off-balance-sheet items. These products would not appear on the balance sheets of financial institutions. This effectively meant that regulatory capital requirements did

204 Funk, Hirschman (n 142) 690–96. By the end of 1992, the OTC derivative market was largely concentrated to roughly 15 banks, of which seven were commercial banks, five investment banks, and three insurance companies, ibid, Table 2, 687.

205 Funk, Hirschman (n 142) 669, 690.

206 Alastair Hudson, 'Banking regulation and the ring-fence' (2013) 107 C.O.B. 1.

207 Section 619 of the Title VI of the Dodd-Frank Act, 12 U.S.C. § 1851.

208 Hossein Nabilou, 'Bank Proprietary Trading and Investment in Private Funds: Is the Volcker Rule a Panacea or Yet Another Maginot Line?' (2017) 32 B.F.L.R. 297, 301

209 ibid 335–40.

210 Adam J Levitin, 'Safe Banking: Finance and Democracy' (2016) 83 U. Chi. L. Rev. 357;

not originally apply to OTC derivatives. This, in turn, allowed financial institutions to expand their business beyond traditional lending of deposit-taking and incurring long-term loans. The rapid expansion in the market could be found from dealing, where the financial institution acted as a principal and traded in its own account, rather than acting as an intermediary for others as a broker for its clients for a commission.[211] Financial regulators were aware of such development and deemed it to be an acceptable banking activity subject to the general requirement of not being made for purely speculative purposes, and that market participants identified and managed the associated risks prudently.[212] From the early-1980s, regulators and especially the Bank for International Settlements and the Basel committee became increasingly interested in the off-balance-sheet exposures of financial institutions and conducted many extensive studies on recent financial innovations in the international interbank market, including those made in the OTC derivatives market.[213] Under the first E.C. Solvency Ratio Directive, that derives its contents from the work carried out by the Basel Committee, assets and off-balance-sheet items were already subject to weighting of risk according to their degree of credit risk, i.e. the risk of non-payment. The off-balance sheet items were to be first 'transformed' into calculable assets through a specific conversion factor. The Capital Adequacy Directive introduced the concept of 'trading books' according to which financial institutions were required to hold funds against losses from adverse fluctuations in the markets.[214] Commercial banks started to use these products with their existing corporate customers, as evidenced by standardized loan documentation that reflected this development.[215] In practice, this meant that the provisions of the lending agreement included specifically drafted provisions in regard to the derivative transactions entered into under a different agreement and created further demand for contractual standardization.[216]

211 Cates (n 87) 838.

212 Henderson (n 85) 365, 393.

213 Cates (n 87) 843–44; George A Walker, 'Financial derivatives - global regulatory developments' (1996) J.B.L. 66, 90:

> It is clear from the above that a considerable amount of very significant and valuable work has been carried out in the area of derivatives especially with regard to the proper identification and assessment of all of the specific financial risks involved [in the OTC derivatives] industry.

214 Council Directive of 18 December 1989 on a Solvency Ratio 89/647/EEC for Credit Institutions OJ L386 (Solvency Ratio Directive); Council Directive 93/6/EEC of March 15, 1993, [1993] O.J. L141 (Capital Adequacy Directive); Federico Torzo, Peter Scherer, 'The capital treatment of credit derivatives in Europe' (1999) 14 J.I.B.L. 144, 145–46.

215 Christian A Johnson, 'At the Intersection of Bank Finance and Derivatives: Who Has the Right of Way?' (1998–1999) 66 Tenn. L. Rev. 1 1998–1999, 1.

216 ibid 44–47.

4.7.5 THE DEMAND FOR CONTRACTUAL STANDARDIZATION

Following the emergence of the OTC derivatives market, new contractual concepts such as 'notional amount', 'netting', and new methods for how to calculate damages upon termination of such novel products were foreign to debt financing but essential for understanding derivatives trading.[217] Importantly, technological advancement and the use of OTC derivatives blurred the line between traditional debt and equity markets in its complexity and flexibility. For example, by way of structuring bespoke equity derivatives, foreign market participants could acquire positions equivalent to US equities, traditionally still a highly regulated area subject to withholding tax regarding outbound dividend payments, without ever acquiring any of the US equities themselves. It was for the public officials to decide how to characterize various equity derivative transactions and how to tax them but without a coherent analytical model as how to do this, '[t]he outcome in any particular [court] case is a matter of sheer speculation'.[218]

There was a clear contrast in the fast pace of derivatives trading, arising from their nature, and traditional forms of finance such as bank lending.[219] In the former, trades needed to be executed orally, typically over the telephone, referred to as trade calls. From the documentation perspective, trades were supplemented with brief telex confirmations that included the economic terms of the transactions. In the traditional area, the negotiation and execution of the written agreement and required supplements could take place even months after the oral agreement.[220] The swap agreements also reflected existing lending documentation but as the payment mechanics, rate setting provisions and the calculation of liquidated damages, for example, were different from bank lending, the end result was often a complex agreement that took a long time to negotiate.[221] There is indeed a disconnect between

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217 For a side-by-side analysis and interlinkages of loan documentation architecture and ISDA MA architecture, ibid 33–44.

218 David P Hariton, 'Equity Derivatives, Inbound Capital and Outbound Withholding Tax' (2007) 60 Tax Law. 313, 317–18. The article focuses on the situation in 2007 and the assumption here is that the situation was no clearer than it had been in the 1980s and 1990s. ISDA MA 1992 addressed this issue by standardizing a provision for 'Tax Event' which allows the party affected by a tax to simply terminate the transaction affected by the tax. The affected party can be either the party who would otherwise have to 'gross up' its payment to negate the effect of the tax or the party who is to receive less because of the withholding tax. Harding (n 21) 76–77, 232–33.

219 See for example Lynn (n 83) 301, noting that even when the counterparties, who already standardized master agreement architecture at their disposal, often signed the master agreement *after* entering into the derivative transaction.

220 Typically, the fulfilment of what is referred to as 'conditions precedent' that the borrower must satisfy before the borrower is entitled to draw funds under the loan arrangement and a legal opinion from the borrower's legal advisor confirming that, among other issues, the signatories of the borrower have the legal capacity to sign the loan documentation. For conditions precedent generally, Zakrzewski, 'Loan Facilities' in Paterson, Zakrzewski (n 32) 110, 134–9.

221 Cunningham (n 28) 27.

a theory which assumes that all transactions are in written form while it has been a long-time market practice that they may not become documented at all.[222]

When the trading volumes grew, the exchange of written contracts became more of a formality as the contractual foundation of a transaction.[223] This led to several problems. First, some jurisdictions might not recognize oral agreement as enforceable as enforceability would require the transaction to be in written and signed form. Second, the time gap between the oral agreement and the closing of the transactions in written form gave rise to *operational risk*, in this case the risk that the terms and conditions of a transaction did not match between the two.[224] Even without delays, the parties might not even be aware of the possible contractual misunderstandings as they did not have the agreement in writing and even when they finally did, the contracts were drafted on the basis of their own standard agreements where the definitions might have been the same wording but not in how they were interpreted giving rise to what came to be referred to as *operational* or *documentation risk*.[225] The answer to overcoming such problems could be found from a *master agreement structure* that would set the basic terms and conditions applicable to all later derivatives transactions entered into between the counterparties. Under the master agreement structure, the counterparties would only need to exchange a short document setting out the economic terms of the individual transactions and this, given it included only the economic terms and was thus short, could be exchanged on the same day as the oral agreement.[226] The problem was that no such master agreement structure existed

Philip R Wood has studied how illegality clauses were already in use in the 1970s and they can be traced back to the US and the 1930s when so-called 'Trading with the Enemy' legislation was in force. An embargo, for example, set under the legislation could lead to a situation where a creditor financial institution was prohibited from acting with a borrower in one jurisdiction while being contractually obliged to lend to the same under the governing law of the contract. In such a situation, a financial institution could cancel its commitment to the debtor. [227] It was also observed at an early stage that derivatives could be or become unlawful. The main legal risk was that it could constitute illegal gambling or wagering both in the US, the UK, as well as elsewhere, as derivatives transactions could be characterized or recharacterized to

222 Hudson (n 35) para 2–27.

223 Cates (n 87) 838.

224 Operational risk is a context-dependant concept, the purpose of which is to allow for the recognition of different types of risk, Loader (n 117) 157–65.

225 Cunningham (n 28) 27; Diane Genova, Don Thompson 'A Guide to Standard Swap Documentation' (1988) 3 Com. Lending Rev. 44; Guylaine Charles, 'The ISDA Master Agreement – Part I: Architecture, Risks and Compliance' (2012) January-February, Pract. Compliance & Risk Mgmt. for the Sec. Indus, 25, 26–27.

226 Cunningham (n 228) 35.

227 Philip R Wood, 'Sovereign Syndicated Bank Credits in the 1970s' (2010) 73 Law & Contemp. Probs. 7, 20.

include a speculative element without commercial basis. The application of such laws to derivatives would effectively mean that such contracts could be rendered void and unenforceable.[228] To add further uncertainty, there was no case law available that would address such issues.[229] Swaps had to be drafted to have a commercial basis to avoid it being construed as illegal wagering or gambling. By claiming that a swap transaction reflected actual risks and contractual obligations of the counterparties, it was hoped that a court would not deem such action to constitute gamgling or wagering.[230] In the UK, the Financial Services Act in 1986 exempted OTC derivatives from constituting illegal gaming or wagering.[231]

As in every financial arrangement, there was the question of if and how would local tax laws affect transactions. Again, this issue had been addressed and even contractually standardized already in the sovereign syndicated lending market in the 1970s that, in turn, had proliferated from the eurocurrency market in the 1960s.[232] The market practice was already that if either of the parties was under local tax laws obligated to withhold tax, the affected party should nevertheless pay the other party in full and thus 'gross up' the amount of the tax payment on the principal. Local tax laws hit local companies in two ways, first in the form of tax, and second, through contractual gross-up obligation.[233] Tax gross-up provisions are market standard in virtually any type of modern standardized transnational contract, and, in the ISDA MA architecture, the affected party is protected with the option to terminate those transactions affected by the tax.[234]

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228 William P Rogers, Jerry W Markham, 'The Application of West German Statutes to United States Commodity Futures Contracts: An Unnecessary Clash of Policies' (1987) 19 Law & Pol'y Int'l Bus. 273

229 Somer (n 88) 404–05.

230 Cates (n 87) 837, n 5. The same care in drafting would also relate to avoiding the derivatives being construed as insurances, a regulated product, 845; Ronald L Cheng, 'Legal Doctrines Restricting the Secondary Market in Interest Rate Swaps' (1988) 26 Colum. J. Transnat'l L. 313, 325–28. While life insurance companies were prohibited from entering into derivatives transactions, the regulations in this respect were laxed in the early 1980s, at least in the US, which allowed insurers to invest a portion of their assets to options and futures for hedging purposes. E Grala Bronislaw, John W Osborn, 'Hedging with Options and Commodity Futures under the Revised New York State Insurance Law' (1984) 16 Conn. L. Rev. 477.

231 Financial Services Act, 1986, ch. 60, pt.1, ch. V, § 63 (1):

(1) No contract to which this section applies shall be Void or unenforceable by reason of—

(a)section 18 of the [1845 c. 109.] Gaming Act 1845, section 1 of the [1892 c. 9.] Gaming Act 1892 or any corresponding provisions in force in Northern Ireland; or

(b)any rule of the law of Scotland whereby a contract by way of gaming or wagering is not legally enforceable.

The exemption was maintained in later Acts, Ross P Buckley, 'Reconceptualizing the Regulation of Global Finance' (2016) 36 Oxford J.Leg.St. 242, 246–48.

232 Subchapter 3.4.4.

233 Wood (n 32) 19; Andre WG Newburg, 'Financing in the Euromarket by U.S. Companies: A Survey of the Legal and Regulatory Framework' (1977–1978) 33 Bus. Law. 2171, 2177–78.

234 For an example of tax structuring under the LMA standard lending documentation, Adam Blakemore, Oliver Iliffe, 'Sub-participations, taxation and the mitigation of lender credit risk' (June 2011) Butterworths Journal of International Banking and Financial Law

More specifically to derivatives market, there was the question of how payments made and received during the duration of the swap agreement would be seen from a taxation perspective and would they give rise to a chargeable gain or allowable loss.[235] In addition, and remembering that this was before the liberalization era, many jurisdictions had local withholding tax arrangements in force, as part of exchange controls or otherwise, which raised the question of which party and on what basis should they be liable for the taxes if they would become applicable to the derivatives transactions. Under English law, it was for the party making a payment under a derivatives contract that was required to deduct tax before making a payment to the other party meaning that the transferee would receive the payment deducted with the withholding tax amount.[236] However, under certain conditions banks incorporated in the UK and UK branches of foreign banks were exempted from this requirement provided that the financial entity in question was acting as a principal on its own behalf and not as an arranger for others.[237]

Third, there was the issue concerning which valuation methods should be used in various transactions outside default situations and what should be the reference interest rate for the same. This aspect would come very much to the forefront of close-out netting calculations. Already in the early 1980s, English or New York laws were deemed the most suitable as the governing law of swap contracts.[238] In regard to other relevant terms and conditions, the issue of how to calculate the payable amount and compensation prior to the scheduled maturity of the transaction was deemed uncertain and therefore in need of further contractual standardization to reflect 'reasonable market calculations'.[239]

Overall, there is clear evidence of how contractual standardization was already at this time driven by market demand for recognition of various risks and relative contractual simplicity, meaning that the issues were complex, but this complexity could be reduced through contractual standardization. The ISDA Master Agreement architecture discussed in detail in the following Chapter was at least partially built on existing processes and solutions found already in the market by market participants that had engaged in repeated interactions and thus had created spontaneously a transnational normative order for their dealings.

235 Watkins (n 87) 2, 31. Under English law, the status of OTC derivatives contracts was clarified under the Financial Services and Markets Act. Simon J Leifer, 'Legal issues relating to the ISDA Master Agreement from the European and US Perspectives' in Harding (n 21) 385–86.

236 Indemnity clauses are a typical way of dealing with this legal risk, which essentially means that the party which is subject to the withholding tax nevertheless has to gross up the payment for the other party. Harding (n 21) 45. The European Central Bank views domestic withholding tax regulations serving to disadvantage foreign intermediaries as a '[b]arrier to an efficient EU clearing and settlement environment' European Central Bank, 'The Payment System: payments, securities and derivatives, and the role of the Eurosystem' (2010) 208.

237 Cates (n 87) 840, n 5.

238 James A Watkins, 'Legal Issues and Documentation' in Boris Antl, *Swap Financing Techniques* (Euromoney Publications Ltd 1983) 99–114.

239 Schuyler K Henderson, 'Credit Risk and Swap Exposure' in Antl (n 238) 115–123.

5. TRANSNATIONAL CONTRACT: THE ISDA MASTER AGREEMENT

5.1 BILATERAL CLOSE-OUT NETTING FROM PUBLIC POLICY PERSPECTIVE

Before going into the evolution of the ISDA Master Agreement, it is necessary to review why the OTC derivatives market matters from a public policy perspective. Transnational contracts are used by policy makers to decrease risks in the financial markets. This is meant to be achieved through allowing for close-out netting and margining the use of which the ISDA MA architecture facilitates. The size of the OTC derivative market is often overstated if the nominal value is used as a benchmark. This might lead the reader astray.[1] In a notional amount, the size of the OTC derivatives market has varied from \$350 trillion to \$700 trillion during 2008–16.[2] In comparison, market capitalization of listed companies globally was roughly \$76 trillion at the end of 2016.[3] The nominal amount refers to gross nominal value of all payments arising from OTC derivative transactions. It does not directly indicate the amount of potential losses and actual credit exposures in this market but serves more as a rough proxy of the potential total price risk transferred in this market.[4]

Instead, a more realistic figure of the OTC derivatives market can be calculated through gross market value which is defined as the value of all outstanding contracts before netting.[5] The term 'gross' refers to the calculation of all positive and negative-value contracts separately without offsetting them for individual counterparties. At the end of 2016, the gross market value of the OTC derivatives positions was calculated at \$15 trillion. Lastly, and importantly for this research, the gross credit

1 The narrative of 'hundreds of trillions of OTC markets' is persistent in academia. Jan D Luettringhaus, 'Regulating Over-the-Counter Derivatives in the European Union – Transatlantic (Dis)Harmony after EMIR and Dodd-Frank: The Impact on (Re)Insurance Companies and Occupational Pension Funds' (2012) 18 Colum.J.Eur.L. 19, 20; Richard Haynes, John Roberts, Rajiv Sharma, Bruce Tuckman, 'Introducing ENNs: A Measure of the Size of Interest Rate Swap Markets' (2018) US Commodity Futures Trading Commission Research Paper, <www.cftc.gov/idc/groups/public/@economicanalysis/documents/file/oce_enns0118.pdf>, accessed 1 June 2019.

2 Bank for International Settlements, 'Statistical release OTC derivatives statistics at end-December 2016' (May 2017) Monetary and Economic Department (BIS Statistics 2017) Annex A <https://www.bis.org/publ/otc_hy1705.pdf> accessed 1 June 2019.

3 Stocks traded, total value (current US\$), World Federation of Exchanges database <https://data.worldbank.org/indicator/CM.MKT.TRAD.CD>

4 Bank for International Settlements, 'Triennial Central Bank Survey of Foreign Exchange and OTC Derivatives Market Activity Reporting guidelines for amounts outstanding at end–June 2016 for non-regular reporting institutions' (BIS Survey 2016) 4 <https://www.bis.org/statistics/triennialrep/2016survey_guidelinesoutstanding.pdf> accessed 1 June 2019.

5 ibid 5, 16.

exposures, which adjust gross market values for legally enforceable bilateral netting agreements, reflecting the market value or replacement cost for each transaction was $3.3 trillion at the end of 2016. [6]

5.2 THE TRANSNATIONAL ORIGINS OF BILATERAL CLOSE-OUT NETTING

5.2.1 PRIVATE NORMATIVITY IN THE MAKING: THE BIRTH OF ISDA

The birth of ISDA, originally known by the name Swap Dealers Association, Inc., may well have taken place in 1984 in a meeting of 18 financial institutions. The purpose of the meeting was to discuss how to reduce the high transactions costs of negotiating and drafting the terms and conditions for each swap.[7] This meeting was the starting point for the transnationalisation of the OTC derivatives market. After consuming negotiations concentrating on battle of forms, everyone wanted to use their own familiar terms and conditions as the basis for further standardization. The first draft consisted only of the standard definitions known as the Code of Standard Wording, Assumptions and Provisions for Swaps, which came in two editions, the first in 1985 and the second in 1986 (together the Code). The Code was a non-binding industry code of practice,[8] and was neither a contract nor a regulation.

The purpose of the Code was to standardize the two sets of valuations. First, how to valuate floating rate options and the cash flows for a US dollar denominated interest rate swap, and second, how to valuate a swap when it was terminated before its intended maturity. In addition, it included standardized wording for certain events of default as well as standard representations and warranties.[9] The valuation methods chosen for the Code were also those that the market participants had found easy to understand and straightforward in their application. In addition, it included choice of law and governing law provisions. From the outset, the users of the Code were free to deviate from the standardized wording and also amend

6 BIS (n 2) 2.

7 This was also the year when the International Primary Market Association (IPMA, currently the International Securities Market Association (ISMA) was established to improve legal documentation, ‘to create a closer liaison with government bodies and other organizations that affect the development of the new issues business’ and to coordinate the development of trading practices of its members on a non-binding basis. Peter Gallant, *The Eurobond Market* (Woodhead-Faulkner 1988) 163–64; Daniel Cunningham, ‘Swaps: Codes, Problems and Regulation’ (1986) 5 Int’l Fin. L. Rev. 26, 27.

8 Cunningham (n 7) 27. For a side by side comparison of the 1985 and 1986 editions of the Code, ibid, 30–32; Jeffrey F Golden, ‘Setting Standards in the Evolution of Swap Documentation’ (1994) 13 Int’l Fin. L. Rev. 18.

9 Philip P Wood, ‘Sovereign Syndicated Bank Credits in the 1970s’ (2010) 73 Law & Contemp. Probs. 7, 20.

it, as some individual financial institutions did, to cover other types of swaps than US dollar interest rate swaps.[10]

Although the Code was widely adopted in the market, negotiating transactions was still slow.[11] Many terms and conditions were scattered in several different agreements that market participants continued to use.[12] Although not a contract, financial institutions could incorporate the Code into their own agreements.[13] The Code was 'more like a dictionary or menu of relevant provisions' from which the parties could use in its entirety or incorporate parts or amend it to suit particular needs of a given transaction.[14] The Code also addressed the legal risk of *cherry picking* and *automatic stay* arising from the US Bankruptcy Code which were a particular concern for those trading in OTC derivatives.[15] Reducing these risks through would soon become central public policy objective.

As said, those who wished to use the Code needed to enter into an additional supplement agreement in order for a swap transaction to constitute a legally binding agreement. A Code would not suffice. The terms and conditions of these supplement agreements, in turn, were not standardized meaning that there was still much perhaps unnecessary negotiation left for market participants to do, even if the Code offered uniform formulations for some but not all terms and conditions. Fortunately for market participants, there was already an existing market solution to this problem. One other similar code already in use, the British Bankers' Association's standard terms (BBAIRS Terms), consisted of a master agreement structure. This meant that all the general terms and conditions applicable to all transactions were standardized, which would be applicable to all individual transactions executed under the BBRAIRS terms. Under the BBAIRS Terms, parties to a transaction needed to exchange only one additional confirmation page that specified the exact economic terms of an individual transaction, to create a binding agreement.[16]

10 Cunningham (n 7) 26.

11 Cunningham (n 7), noting that in non-ISDA standardized agreement '[m]uch time was spent on the negotiation of payment mechanics, rate setting provisions and liquidated damages' 27.

12 Diane Genova, Don Thompson, 'A Guide to Standard Swap Documentation' (1988) 3 Com. Lending Rev. 44, 45; Schuyler K Henderson, 'Swap Credit Risk: A Multi-Perspective Analysis' (1988) 44 Bus. Law. 365, 385–86; Paul C Harding, *Mastering the ISDA Master Agreements*, (3rd edition, Pearson Education Ltd 2010) 18.

13 Sean S Flanagan, 'The Rise of a Trade Association: Group Interactions Within the International Swaps and Derivatives Association' (2001) 6 Harv. Negot. L. Rev. 211, 234–38; Edmund MA Kwaw, *The Law and Practice of Offshore Banking and Finance* (Quorum 1996) 185; Cunningham (n 7) 26–28.

14 Golden (n 8) 18–19; Stuart Somer, 'A Survey of Legal and Regulatory Issues Relevant to Interest Rate Swaps' (1992) 4 DePaul Bus. L.J. 385, 406–07; The Bank for International Settlements, 'Recent innovations in international banking' (April 1986) acknowledging the contractual standardization carried out by ISDA, 59–60, as well as the important role of investment banks as standardizers of contracts and market practices, 45, ending in an observation that '[i]n general, however, the progress toward standardisation of OTC options across banks or among national markets has been slow' 76, <https://www.bis.org/publ/ecsc01a.pdf> accessed 1 June 2019.

15 Cunningham (n 7) 32–34.

16 Cunningham (n 7) 28–29. The article also contains a side-by-side comparison of approaches and assumptions of the Code and the BBAIRS Terms, 29.

However, BBAIRS Terms were meant for short-term interbank transaction in the London market for which reason they could serve only as the starting point for further standardization for the OTC derivatives market. Market participants adopted the basic idea of the BBAIRS Terms of having a master agreement under which transactions could be made on pre-defined and standardized terms and conditions.[17] Following this development, market participants learned to 'speak a common language'. The concepts and vocabulary were understood increasingly in a consistent coherent way, albeit disputes over the contents and meaning of the terms and conditions were still common between market participants. Regardless of this, as early as 1986, it was evident that 'future cooperation may well lead to a standard form agreement that works under both English and New York law'.[18]

Contractual standardization was a method to drive down negotiation costs as well as to identify legal risks of OTC derivatives trading. Turning financial transaction into contractual terms is slow and costly. This might have held truth especially in the emerging OTC derivative market that was fast-paced, novel, and took place in a complex legal and regulatory environment full of legal risks. The growth of this market was spontaneous in that nobody could predict how popular each type of derivative product would become. The market generated supply and demand for further standardization. Scalable terms and conditions facilitated trading in new types of transactions.[19] Contractual may also have had also the unintended effect of discouraging market participants from requiring such terms and conditions from their counterparties in derivatives transactions that they would normally require in their lending operations. These shortcomings in proper documentation varied from identifying the legal status of the counterparty and ensuring that the counterparties had the corporate powers to enter into OTC derivative transactions to proper monitoring of the credit risk of their counterparties during the life of a transaction.[20]

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17 Henderson (n 12) 386.

18 Cunningham (n 7) 26, 28; Josephine Carr, 'Eurobonds Know No Bounds' (1987) 6 Int'l Fin. L. Rev. 7; Golden (n 8).

19 Genova, Thompson (n 12) 44; Theodore Kim, 'A hundred ways to slice up credit' (1998) 347 Euromoney, London 97, noting the industry demand not only for contractual standardization, but also for market information and for the development of common benchmarks for the pricing of risk. According to an industry estimate, the total notional amount of outstanding interest rate and currency swaps increased many fold during 1987–1991. For example, during that period, the notional amount of interest rate swaps grew from 388 to 1.622 billion US dollars and for currency swaps from 86 to 328 billion US Dollars, The Group of Thirty, Washington, DC, Working Group on Global Derivatives, 'Derivatives: Practices and Principles – Global Derivatives Study Group, July 1993, 51–56 (Global Derivatives Study Group) <https://group30.org/images/uploads/publications/G30_Derivatives-PracticesandPrinciples.pdf> accessed 1 June 2019. According to another estimate drawn from an industry study, the respective figures rose from 1.622 to 8.698 billion U.S. dollars and from 328 to 455 billion U.S. dollars during 1991–1995, Gautam Goswami, Milind M Shrikhande, 'Interest Rate Swaps and Economic Exposure' (1998) 9 Global Finance Journal 51, 54.

20 Henderson (n 12) 387–88, also noting that those financial institutions offering other services to their clients would have an incentive to monitor their counterparties whereas in trading functions '[a] dealer which views its swap activities primarily as a trading function may take a more liberal approach to documentation, relying on the public rating of its counterparties' 388.

The 1985 version of the Code was updated in 1986 to better reflect new market practices that had come into existence and evolved within one year. The new version differentiated market mechanism in a more nuanced way and introduced new definitions. In addition, market participants had found some of the key provisions of the 1985 Code complex and difficult to understand. These provisions were central as they determined how the value of a swap should be calculated when it is terminated before its maturity. Market participants had found one standardization, the so-called Agreement Value provisions, easier to understand than the alternative. The 1986 version included a redrafted Formula and explanatory sentences to guide readers on its interpretation.[21]

5.2.2 FROM A NON-BINDING CODE TO A BILATERAL AGREEMENT

New negotiations ensued. Unlike the first negotiations which were between dealer financial institutions, the following negotiations had to take into consideration and be counterbalanced with the views of those who bought OTC derivatives for their own use, the end-users, transnational corporations. The legal nature of the Code evolved from being a non-binding collection of standardized contractual terms and conditions towards being a standardized ISDA Master Agreement in 1987 (ISDA MA 1987). ISDA introduced two new forms, one for the US market and one for the 'London market', i.e. for the rest of the world. An 'Interest Rate and Currency Exchange Agreement' was designed to be used only in the US dollar interest rate swap market and was thus to be governed by New York law and under the jurisdiction of the New York courts. The 'Interest Rate and Currency Exchange Agreement' (multi-currency form) was to be used in the latter and be governed by English law and under the jurisdiction of the English courts (together the Forms). The multi-currency form was soon accompanied by the '1987 Interest Rate and Currency Exchange Definitions' (the Definitions) to further facilitate swap trading now in 15 different currencies.[22] The market had grown significantly over the course of just a few years and new derivative products were 'used in conjunction with, or as integral part of, virtually every other type of financial transaction'. Derivatives were becoming the main transaction instead of bank lending and capital market

21 Cunningham (n 7) 26, 31. The explanatory sentences would in a few years evolve into separate guide books published by ISDA used also in this research as sources.

22 Genova, Thompson (n 12) 45, noting that '[t] oday, virtually all major market participants have adopted the International Swap Dealers Association, Inc. (ISDA) codes and forms for documenting interest rate and currency swaps'; Bank for International Settlements, '62nd Annual Report' (15th June 1992), noting the rapid expansion of the swap market and the concentration of the market towards inter-ISDA member transactions, 180 <https://www.bis.org/publ/arpdf/archive/ar1992_en.pdf> accessed 1 June 2019.

transactions. Bonds were issued, and loans were made for facilitating trading in derivatives.[23]

ISDA MA 1987 introduced standard wording for various situations that could affect the economics of a transaction and give rise to legal issues. These situations ranged from mergers, payment provisions, netting mechanism for payments, contractual clauses on agreement assignment to third parties, new default provisions, and three alternative indemnification clauses, among others.[24] As a sign of heavy sell-side, in other words, the dealer side, involvement in the drafting process, ISDA MA 1987 also introduced a close-out calculation method referred to as 'one-way payment'. It basically means that only the defaulting party should pay for damages to the non-defaulting party upon default. The basic assumption among dealers was that the defaulting-party would be their client/counterparty for which reason there was essentially no need to consider an inconceivable situation where a dealer institution would default and be liable to pay for damages. The assumption serves also as a period piece of how banking was seen at that time. Without going into detail over one-way, limited two-way, or two-way payments, it suffices to note that two-way payment would become the market standard by the early 1990s.[25]

The next version of the 1987 Definitions was published in 1991. This version expanded the scope of the Definitions from standardized interest and currency swaps to, among others, commodity and equity indices. As a reflection of the evolution taking place in the market, the 1991 Definitions introduced an open-ended definition which allowed market participants to state that Swap Transactions (as defined in the 1991 Definitions) are those transactions that the parties to an agreement want to define a transaction as such. It also introduced new optional terms, basically menus of terms and conditions, for certain definitions as in some market areas certain definitions were understood differently than in others.[26] It was for ISDA to keep up with the constantly evolving market preferences in contractual standardization and for the market participants to analyze how well the standardized terms and conditions fit into their own transactions and amend it accordingly, if deemed necessary.[27] From early on, market participants could justifiably say that the ISDA

23 Schuyler K Henderson, 'Derivatives law as a niche area is dead' (1997) 12 J.I.B.L. 351, 353; Richard Benzie, 'The Development of the International Bond Market' (1992) BIS Economic Papers No. 32, noting that '[a] substantial but unknown proportion of international bond issues are associated with a swap transaction' 70, <https://www.bis.org/publ/econ32.pdf>; Chapter 4 (n 203).

24 Isabel Pappe, 'The ins and outs of swap transactions' (1989) 15 CBLJ 158.

25 Alastair Hudson, *The Law on Financial Derivatives* (5th edition, Sweet & Maxwell 2012) 121–22, 253–54; Pappe (n 24) n 780.

26 Christopher Bell, '1991 ISDA Definitions: Evolving with the Market' (1991) 10 Int'l Fin. L. Rev, 26, 28, for a timeline of the evolution from 1985 to 1990, 28; Pappe (n 24) n 780. The 2006 ISDA Definitions covered different types of 'plain vanilla' products that is 158 pages long whereas Definition booklets are generally 40–70 pages long. The Definition booklets are 'not very easy to read and include frequent cross-references but on the whole they work well provided they are used critically', Harding (n 12) 21–22.

27 Mark P Zimmet, 'ISDA Master Agreement: can a creditor swipe your swap?' (1998) 17 Int'l Fin. L. Rev. 13.

MA provisions were the market standard, which in turn could be used as an argument in court proceedings should disputes arise. Especially a standardized methodology over the determination of damages upon termination, which is a nuanced and a market-specific question borne out of market practice, could prove to be beneficial in convincing courts that such issues should be determined in accordance with the provisions of the ISDA MA. In other words:

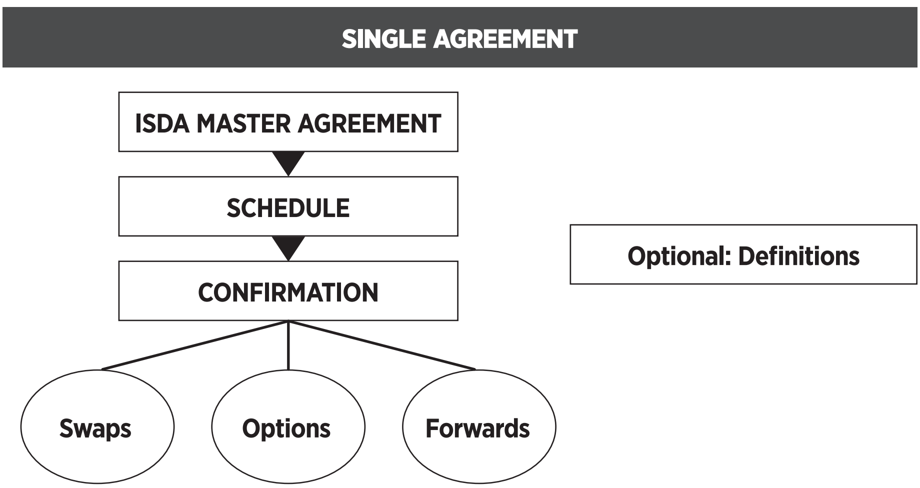
> Among the most significant and beneficial effects of the standardization process may be the development of an industry wide practice through the ISDA agreements and the influence of this practice on judges called upon to determine damages.[28]

The ISDA MA reflected prevailing market practices, or the lex mercatoria of the OTC derivatives market from its early beginnings.

5.2.3 ISDA MASTER AGREEMENT 1992

While new products could be categorized generally as 'derivatives', they could vary considerably as to their economic terms and how and for what they were used in the markets. These new product categories could, however, be attached to the ISDA MA architecture by including a simple reference to the new Definitions booklets stating that this Definitions shall form part of the Schedule or Confirmation of the ISDA Master Agreement.

TABLE 1 Simplified Architecture of the ISDA Master Agreement 1992



28 Henderson (n 12) 379–80.

The counterparties could thus enter into different types of transactions across product categories under the single agreement structure. The contractual standardization evolved to the next stage through the introduction of ISDA Master Agreement 1992 that came out in two versions (both versions referred together as ISDA MA 1992). The Local Currency-Single Jurisdiction version was to be used for transactions where both parties are in the same jurisdiction and enter into transactions in the currency of that country. The Multicurrency-Cross Border version was published in January 1993 after lengthy negotiations between market participants that might have taken as long as two years.[29] ISDA MA 1992 introduced significant alterations to the 1987 version to balance the terms and conditions from non-defaulting party friendly, reflecting the earlier heavy involvement of dealer banks in the standardization process, to more neutral towards end-users. Importantly, following the demand for further standardization, the International Swaps and Derivatives Association Inc. as it was now known reflecting the expansion of the OTC derivatives market beyond swap structures, soon introduced new definition booklets that the contracting parties could opt to use under the Master Agreement in different market areas.[30] ISDA also published a separate User's Guide to the 1992 ISDA Master Agreements in January 1993 that was, albeit highly technical and nuanced, the main interpretative document for the 1992 ISDA MA.[31]

The basic three-part architecture of the ISDA MA, Master Agreement Form-Schedule-Confirmation has remained the same to this day at least in bilaterally cleared OTC derivative transactions. First, ISDA MA 1992 introduced the standardised template that includes the terms and conditions applicable to all derivative transactions executed under the ISDA MA 1992 architecture by its signatories. It was accompanied by two other documents, the Schedule and the Confirmation. Attention was paid to those terms that ensured that the counterparties had the corporate authority to trade in derivatives. In addition, the ISDA MA 1992 included provisions for payment netting, novation netting, and close-out netting and basic types of events of default or termination events (such as non-payment or illegality) that give the non-defaulting party the right, but not the obligation, to terminate all or some of the transactions following a termination event.[32]

Second, ISDA MA 1992 included a Schedule in which the counterparties could structure individual transactions applicable to certain transactions executed under

29 Harding (n 12) 24.

30 Flanagan (n 13) 229; Golden (n 8) 19.

31 Harding (n 12) 31.

32 Under the ISDA MA architecture, the other party, or in some cases both parties, can terminate some or all transactions through event of default and termination provisions. In simple terms, events of default are situations where one of the parties have failed to fulfill their obligations as to their own fault (for example, non-payment) which can lead to close-out termination of all transactions whereas termination events concern situations that are neither of the parties fault such as changes in tax laws affecting one of the parties. Harding (n 12) 87–110 (for ISDA 1992 MA), 225, 249, 249–82 (for ISDA 2002 MA).

the MA structure. ISDA MA architecture leaves it up to the parties to opt in or out on Schedule level of the most usual terms and conditions from which the counterparties can choose from or draft, or 'tailor', additional types on a case-by-case basis. The terms and conditions agreed in the Schedule prevail over those contained in the ISDA MA, meaning that if there is a discrepancy between the ISDA MA and the Schedule, the wording of the latter is applied.

Third, under ISDA MA 1992, each transaction executed orally was to be accompanied by a written Confirmation with a statement that the transaction is governed by the ISDA MA entered into between the counterparties.[33] Following the logic of a master agreement structure, the Confirmation prevails over the Schedule and the Form. The Confirmation was designed with the intent that only the key economic terms and contractual obligations would be included to it. While the Confirmation itself could be only a single page long, each individual term on it would have to be carefully drafted to properly reflect the architecture of the ISDA MA from definitions including business days, day count fractions, reference rates, and payment instructions.[34] The cross-border element of derivatives transactions was becoming more evident. The Confirmation could either serve as an evidence of a binding oral agreement entered into earlier between the traders, or for those jurisdictions requiring the transaction to be in written form, as the document that rendered the transaction into an actual enforceable agreement.[35] Following technological development, paper Confirmations would gradually be replaced to some extent by electronic Confirmations, especially among dealers who have the technical capability to do so, the aim of which is to allow easier and quicker trade execution.[36]

5.2.4 ISDA MASTER AGREEMENT 2002

The next version of the ISDA master agreement was published in 2003. It became known as the ISDA Master Agreement 2002 (ISDA MA 2002). Unlike ISDA MA 1992, it was published only in a multicurrency cross-border format. The review, negotiation and drafting of ISDA MA 2002 took 12 months to complete. Based on a review carried out by ISDA, this process was also influenced by a policy group consisting of 12 transnational financial institutions. This policy group had already in 1999 noted the risks associated with inconsistencies across different standard

33 Genova, Thompson (n 12) 46–49.

34 David M Lynn, 'Enforceability of Over-the-Counter Financial Derivatives' (1994) 50 Bus. Law. 291 291, n 93.

35 Norman Menachem Feder, 'Market in the Remaking: Over-the-Counter Derivatives in a New Age' (2017) 11 Va. L. & Bus. Rev. 309, 350.

36 ibid 354.

form documents used in the OTC derivatives market.[37] These risks concerned termination, valuation, and close-out issues and problems associated with both loss and market quotation provisions of the ISDA MA1992. Among others, the review led to the standardization of new termination events, such as force majeure, impossibility of performance, and sovereign event, which is a risk that an act of state somehow restricts a counterparty from fulfilling its contractual obligations.[38]

The review also identified potential problems in the cross-product applicability of close-out netting provisions and called for a review of the existing ISDA collateral documentation. Originally, the plan was to expand the ISDA MA 1992 with a total of 14 new Annexes. However, contrary to the idea of contract standardization, the project was leading to increasing complexity rather than reduction of the same.[39] For this reason, it became evident that a new version of the ISDA MA would be beneficial and could prove to be popular among market participants considering the changes in legislation, new case law, market practices, and technological development.[40] ISDA MA 2002 followed the ISDA MA 1992 version closely.[41] Up to 1025 individual differences were evident in the newer version, however, from minor clarifications to core issues like the close-out method.

5.2.5 CLOSE-OUT METHOD: INTERACTIONS BETWEEN FINANCIAL REGULATION, LEX MERCATORIA, AND THE ENGLISH COURTS

It was a widely held opinion among G-10 supervisory authorities that '[t]he correct method of assessing the credit risk on these [swap] items is to calculate the *current replacement cost* by marking to market, a technique that determines, among other issues, the exposure of a counterparty towards its counterparty on a certain date, and to add a factor to represent potential exposure during the remaining life of the contract'.[42] This view would later be reflected in the ISDA MA 1992 close-out netting method. Under the ISDA MA 1992, the replacement cost was to be calculated on a mark-to-market basis by obtaining market quotations from three or more swap

37 Harding (n 12) 167–68, noting also that a significant impetus for this report were the market events that occurred in 1997/1998 especially in the Asian and Russian markets.

38 It is market practice to wait out events that may affect trading. Terminating transactions immediately, even if the agreement would allow a party to master agreement to do so, would generally be contrary to market practice. Therefore, termination provisions generally guide market participants to wait for a few business days to assess the actual implications of an event that affects trading. John Berry, 'ISDA Sets New Standard for Derivatives' (2003) 22 Int'l Fin. L. Rev. 19, 20–21; Chapter 4, n 21.

39 Harding (n 12) 168, 506–07, 539–40.

40 Berry (n 38) 19.

41 Hudson (n 25) para 2–96.

42 Basel Committee on Banking Supervision, 'International Convergence of Capital Measurement and Capital Standards' July 1988, Basel, 13–14, 25, <https://www.bis.org/publ/bcbs04a.pdf> accessed 1 June 2019 (emphasis added).

dealers in the market according to which the non-defaulting party determines the final close-out amount.[43] The adoption and approval of close-out netting by the Basel Committee allowed market participants to substantially reduce the capital requirements for their OTC derivatives trading. ISDA continued to facilitate and lobby for the recognition of close-out netting.[44]

Contractual standardization facilitated, if not created, market practices that allowed for the reduction of legal risks. Importantly, ISDA standardized two alternative close-out methodologies for the termination of all transactions upon counterparty default. In the ISDA 1992 MA, these provisions came to be known as *market quotation* and *loss* which both have the same objective of producing a close-out payment obligation, i.e. a net amount payable by one party to the other, but with different methodology that would each bring a different result.

To summarise in a manner that cuts away the important nuances but serves here as an illustration, market quotation means that the non-defaulting party selects and requests a quotation, a price, for the terminated transactions from four dealer institutions 'of the highest credit standing' and based on these quotations, the non-defaulting party defines a replacement cost for the terminated transactions. The replacement cost needs to be 'reasonable'. The benefit of this approach is that the calculation of the settlement amount is transparent, as the amount is the arithmetic mean of those quotations.[45] The problem of this method, however, becomes apparent when market conditions are volatile at the time of the quotation request. Termination upon event of default is an extreme measure and rare occurrence that market participants generally seek to avoid. The bankruptcy of a financial institution always has systemic repercussions meaning that the market becomes illiquid and when that occurs, the quotes received can be widely divergent. In addition, as the dealer market is concentrated around relatively few financial institutions, market quotation gave rise to privacy issues as the request for a quote could mean the disclosure of sensitive pricing information to a competitor.[46] The weaknesses of the market quotation became apparent also in a market turmoil at the end of the 1990s. At that time, many counterparties defaulted on their obligations and equally many non-defaulting market participants requested quotations at the same time

43 Robert H Litzenberger 'Swaps: Plain and Fanciful' (1992) 47 The Journal of Finance 831, 838, Appendix A.

44 Tony Shea, 'The Basel Committee Consultative Papers on netting' (1993) 8 J.I.B.L. 314, 316.

45 Guylaine Charles, 'The ISDA Master Agreement – Part II: Negotiated Provisions' May–June 2012, Pract. Compliance & Risk Mgmt. for the Sec. Indus., 33, 33–34; Harding (n 12) 136–37.

46 Harding (n 12) 88. For a report concerning the unauthorized and concealed futures and options trading that led to the bankruptcy of Barings plc, The Board of Banking Supervision and the Bank of England, 'Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings' (18 July 1995) <https://www.gov.uk/government/publications/report-into-the-collapse-of-barings-bank> accessed 1 June 2019.

in a volatile and illiquid market. These experiences were one driver for market participants to seek new ways of calculating the close-out amount.[47]

The loss method was introduced as a fall-back measure to market quotation to be used in situations where the non-defaulting party had a reason to believe that the latter would not produce a reasonable result. Under the loss method, the non-defaulting party determines, acting reasonably and in good faith, its total losses in connection with the master agreement and terminated transactions instead of determining it through quotations from dealers the intention of which is to produce a replacement cost for the terminated transactions.[48] Both market quotation and loss were created by market participants. While they might have been market practice of the OTC derivatives market, this did not mean that courts would deem them as such or render themselves as the rubber-stampers of lex mercatoria. The courts made their own independent evaluation of these terms and conditions to which the market participants were bound to conform. For example, in the English court praxis, the ratio of market quotation and loss was seen broadly as the same contrary to the views of at least some market participants. In short, for English courts, the acquisition of replacement transactions would become the benchmark for valuation regardless of the method chosen by the market participants in their respective ISDA Master Agreements.[49]

This interaction between the modern lex mercatoria and state courts is quite visible to date. The loss method has been criticized over its subjectivity and opacity generally, as it leaves a wide discretion to the non-defaulting party to define its losses, but on the other hand, at least in specific cases it still serves a purpose. The loss method may be the most suitable in illiquid and bespoke derivatives transactions as was more recently established by the High Court in *Fondazione Enasarco v Lehman Brothers Finance*.[50] Fondazione involved an Italian pension fund that had ISDA MA 1992 in place with Lehman Bros Finance SA. Following the collapse of the latter in 2008, the pension fund had, as the non-defaulting party, calculated its loss by making a new similar transaction with another financial institution without obtaining quotations from dealers as stipulated under the market quotation method. The High Court rejected the claim of the Lehman bankruptcy estate which had argued that the replacement transaction was different from the terminated transaction. The Italian pension fund had acted 'reasonably' in accordance with the provisions of the ISDA MA. Especially for more complex products, it may be difficult to obtain any quotes that would produce a reasonable result from other dealers.

47 Charles (n 45) 33–34; Berry (n 38) 19.

48 Harding (n 12) 88–89.

49 Hudson (n 25) paras 3–100–117; Peregrine Fixed Income Ltd v Robinson [2000] C.L.C. 1328; Australia; New Zealand Banking Group v Société Générale [2000] 1 All E.R. (Comm) 682 CA.

50 Fondazione Enasarco v Lehman Brothers Finance SA [2015] EWHC 1307 (Ch).

The High Court reaffirmed the established principles set in English jurisprudence that when the loss method is applied, the close-out amount must be determined reasonably, i.e. 'the non-defaulting party must not arrive at a determination which no reasonable non-defaulting party could come to',[51] and this is what the Italian pension fund had done when it had made a new transaction from another dealer and used the price of this transaction in the close-out calculation.

Termination of all outstanding contracts upon insolvency was the solution that market participants deemed most appropriate and effective. Through negotiations between dealers and end-users, it was ISDA that introduced two methods and a process as to how to arrive to a single net amount. The methods were by no means flawless in that it would prevent legal disputes over the process from occurring. In fact, the interpretation of the ISDA 1992 MA close-out methods has been and continues to be subject to constant litigation because the ISDA MA 1992 is still widely used in the market.[52]

In addition to market quotation and loss methods used in the ISDA MA 1992, there was a market demand for a new standardized method for calculation of settlement amount upon termination. In the ISDA MA 2002, the close-out amount definition and method replaced the market quotation and loss used in ISDA MA 1992.[53] As an example of the interaction between lex mercatoria of the OTC derivatives market and court praxis, it was the language used by an English court in the *Peregrine* case[54] that the drafters of the ISDA MA 2002 used in the formulation of the provision concerning the calculation of the replacement cost of terminated transactions. Following the language of the *Peregrine*, the replacement value was now to be performed in good faith 'using commercially reasonable procedures' in order to produce a commercially reasonable result under the close-out amount.[55]

Like in the market quotation method, close-out amount also involves the calculation of how much it would cost for the non-defaulting party to replace or provide the economic equivalent of the terms of the terminated transactions. One important difference between the two, however, was that the close-out amount provision was more nuanced than the market quotation method in the recognition of how the payments and deliveries under each transaction should be valuated. The close-out amount included a non-exhaustive list of what information the non-defaulting party may take into consideration when determining a close-out amount. As the list was non-exhaustive, it offered the non-defaulting party a wider discretion regarding the valuation of the terminated transactions as long as it was acting in

51 Daniel Harris, 'Valuation of closed-out swaps: a dirty business' (2015) 6 J.B.L. 437.

52 For case-law, ibid n 799.

53 Harding (n 12) 167–68, 200.

54 Peregrine Fixed Income Ltd v Robinson [2000] C.L.C. 1328.

55 Hudson (n 25) para 3–101, para 3–118.

good faith, used commercial reasonable procedures, and the result was commercially reasonable.[56] By this time, ISDA MA architecture had become highly nuanced and its use required significant expertise from its users. The architecture was becoming increasingly more complex despite the standardization of the terms and conditions, or perhaps because of it.[57] Dealers were in the position to require end-users to use the ISDA MA if they wished to enter into derivatives transactions with them.[58] At least in some aspects, the private regulatory mechanisms under the ISDA MA architecture can contribute to moral hazard by allowing the non-defaulting party to have much control over a risk, the realization of which is borne by the defaulting counterparty.[59]

5.2.6 OTHER MASTER AGREEMENTS FOR OTC DERIVATIVES TRADING

The demand for contractual standardization was by no means limited only to the US and the UK as there was also demand for local-language, local-law master derivatives agreements for domestic transactions elsewhere.[60] A similar effort to that of ISDA was made in France in the 1980s and 1990s when two working groups, the Association des Trésoriers de Banque and the Association Française des Banques (AFB), commenced standardization projects similar to those of ISDA and BBAIRS. In 1987, the AFB published its 'Conditions Générales pour les Opérations d'Exchange de Devises et/ou de Conditions d'Intérêts' (Conditions Générales), a set of general principles for trading in swaps. The purpose of Conditions Générales could be described 'as a soft normalization of vocabulary and practice of swap agreements' and their recognition under law as usage. [61]

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56 Berry (n 38) 20; Hudson (n 25) paras 3–128–129.

57 Rodrigo Zepeda, 'The ISDA Master Agreement 2012: a missed opportunity?' (2013) 28 J.I.B.L.R. 308, 318–20, noting that market participants as well as experienced courts 'often floundered with the correct interpretation of Master Agreement provisions' 318.

58 For example, a lender bank could require the borrower to use the ISDA MA when the loan facility has a separate but an interlinked derivative component, Christian A Johnson, 'At the Intersection of Bank Finance and Derivatives: Who Has the Right of Way?' (1998–1999), 1, 40.

59 Carl Baker, 'Rethinking the ISDA flawed asset' (2012) 27(6) J.I.B.L.R. 250.

60 Schuyler K Henderson, *Henderson on Derivatives* (2nd edition, LexisNexis 2010) para 16.8.

61 Pierre-Yves Chabert, 'Trials and tribulations: the legal characterization of swap transactions' (1989) 1 I.B.L.J. 19, 36–39, also discussing the contractual aspects, regulatory treatment and taxation of swaps under French law and noting, 20:

> *[s]waps have been created by practitioners and bankers*, as opposed to most of the other financial instruments in France which have been created by the Parliament or the Treasury within a pre-determined legal framework. It is therefore necessary to define posteriori the legal characteristics of the contract (emphasis added);

Martin Gdanski, 'French interest rate and currency swaps' (1988) 7 In'tl Fin. L. Rev. 23, describing the Conditions Générales as a master agreement structure where the Conditions Générales are incorporated into individual transactions.

The drafters of 'Conditions Générales' had taken inspiration from the Code and BBAIRS and it also included direct cross-references to the same. Importantly, also in France, contractual standardization was a step towards its customary usage globally. The use of multilateral clearing was also envisioned at that time. From the French perspective, contractual standardization was a tool to create and uphold private trade practices, not to replace legislators and public officials.[62] Fédération Bancaire Française published yet another model agreement for domestic derivatives transactions. Another standardized model contract is the Euromaster, first issued by the European Banking Federation in 1999 with the option of using any European law as the governing law. In comparison, neither of them reached any such level of international recognition as the ISDA MA.[63] Likewise in Germany, the Federal Association of German Banks introduced its own master agreement governed by German law in 1990, which was updated in 1993. This master agreement was also built on the same idea of a single agreement structure like the ISDA MA. The similarities in its architecture with the ISDA MA, reduction of legal risks relating to cherry picking and automatic stay, and automatic early termination upon insolvency, served the same purpose of enhancing legal certainty under the laws of Germany.[64] Essentially, the legal questions and legal risks of OTC derivatives trading revolved around similar, if not identical issues, not only in many states like the US, England, France, and Germany, but also in public institutions.

A master agreement structure formed the contractual bedrock of the eurozone project following the establishment of the European Central Bank (ECB) in 1998. The drafters of other master agreements, such as the AFB, had followed ISDA MA architecture closely, which was already by far the most used master agreement in the cross-border OTC derivatives market. Once the competence to define and implement monetary policy had been moved from Member States participating in the euro currency project to the ECB, the Governing Council of the ECB decided that ECB should make use of the existing master agreements to govern the foreign currency reserve assets of the ECB. Depending on the counterparty and its location or place of incorporation, the ECB was to use the AFB for counterparties located in France; a master agreement known as 'Rahmenvertrag für echte Finanztermingeschäfte' for counterparties located in Germany; ISDA MA 1992 (Multicurrency – cross-border, English law version) for counterparties located outside France and Germany and

62 Chabert (n 61) 1 I.B.L.J. 19, 36; Gdanski (n 61) 23.

63 P Durand-Barthez, 'The "governing law" clause: legal and economic consequences of the choice of law in international contracts' (2012) 5 I.B.L.J. 505.

64 Rainer Magold, Gillian Hogarth, 'The 1993 German master agreement for financial futures transactions' (1994) 9(2) J.I.B.L 64; Simon J Leifer, 'Legal issues relating to the ISDA Master Agreement from the European and US Perspectives' in Harding (n 21) 402.

not incorporated in the United States; and ISDA MA (New York law version) for those counterparties incorporated in the US.[65]

The standard-form master agreements required some modifications to make them suitable for the ECB regarding its legal status as a central bank.[66] For example, certain provisions relating to bankruptcy were amended as the ECB could not be declared bankrupt.[67] The cross-default clauses were also amended and widened in their scope.[68] From a contractual standardization perspective, the most ambitious goal of the ECB was to create a 'master-master' netting agreement that would differ from the existing master agreements in two ways. First, this master netting agreement would serve as a master agreement of a master agreement that would allow cross-product netting between OTC derivatives and other financial instruments. For example, this would allow the ECB to terminate different master agreements for OTC derivatives products, governed by a derivatives master agreement such as ISDA MA, and repurchase transactions, governed by repurchase agreement such as the GMRA, upon counterparty default. Second, the aim of the 'master-master' structure was designed to be valid under different jurisdictions.[69]

5.3 TRANSNATIONAL EVOLUTION OF BILATERAL CLOSE-OUT NETTING

Market participants had to invent close-out netting in order not to be 'stuck' with transactions if a counterparty would go insolvent. To repeat, the legal risk laid in automatic stay and cherry-picking that could arise from national insolvency laws. To examine the evolution of close-out netting, it is necessary to differentiate between different types of netting, the most common of which are payment netting (also referred to as settlement netting), novation netting, and close-out netting. Netting can occur between two counterparties (bilateral netting[70]) or between more than two

65 Article 3, subsection 4, and Annex 3, Guideline of the European Central Bank of 3 February 2000 on the management of the foreign reserve assets of the European Central Bank by the national central banks and the legal documentation for operation involving the foreign reserve assets of the European Central Bank (ECB/2000/1), repealed; Guideline of the European Central Bank of 16 November 2001 amending Guideline ECB/2000/1 on the management of the foreign reserve assets of the European Central Bank by the national central banks and the legal documentation for operations involving the foreign reserve assets of the European Central Bank (ECB/2001/12) [2001] O.J. L310/31, repealed.

66 Chryssa Papathanassiou, 'The legal documentation for the reserve asset management of the European Central Bank: the schedules to the GMRA and to the 1992 ISDA Master Agreement, and the Master Netting Agreement' (2002) 4 J.I.F.M. 85.

67 Annex 1 subsection 5, ECB/2000/1 (n 65).

68 Annex 2a, subsection 4, ECB/2000/1 (n 65).

69 Papathanassiou (n 66) 85, 90–91; Simon J Leifer, 'Legal issues relating to the ISDA Master Agreement from the European and US Perspectives' in Harding (n 12) 410–11.

70 The European Central Bank defines bilateral netting as 'an arrangement whereby two parties net their bilateral Obligations', 'Glossary of terms related to payment, clearing and settlement systems' December 2009, 2 < https://www.ecb.europa.eu/pub/pdf/other/glossaryrelatedtopaymentclearingandsettlementsystemsen.pdf> accessed 1 June 2019.

parties (multilateral netting[71]). It refers generally to a process by which parties can reduce their credit exposure and credit risk towards one other by paying net amounts instead of gross amounts. This is generally deemed cheaper and less risky than gross transfers which is why the legal recognition of netting arrangements is favoured as a public policy.[72] Payment netting, novation netting, and close-out netting each serve a different purpose and in the context of early OTC derivatives trading, it became apparent that payment netting and novation netting were problematic if the other counterparty faced insolvency.[73] One of the most important, if not the most important, of the legal risks identified by market participants was the ability to net their payments against an insolvency estate, or similar mandatory and collective liquidation of an insolvent counterparty.[74]

Payment netting was already recognized as a common law doctrine, and likely in every legal system, of set-off. Simply put, payment netting means that counterparties who have payment obligations against each other, accrued claims on debts, due on the same date and in the same currency off-set their respective gross amounts and the other party who owes more pays a net amount to the other. It is a method of reducing the operational burden of sending many settlement messages instead of one. It also reduces credit risk, and settlement risk, as there are fewer transfers than there would be in a gross settlement, and it allows for the calculation of margin.[75] However, it was unclear whether the non-defaulting party could benefit from payment netting also in insolvency of its counterparty. For example, payment netting that would become applicable upon counterparty insolvency, i.e. it would constitute an ipso facto clause, could be viewed by the bankruptcy administrator as preferential treatment of one unsecured creditor at the expense of other unsecured creditors.[76]

The complexity surrounding common law anti-deprivation rule and *pari passu* rule was one central source of legal risk. Market participants wished to include ipso facto clauses to their derivatives contracts that would allow the non-defaulting party to terminate the OTC transactions upon the insolvency of the counterparty. The risk of tying payment netting also to insolvency situations was that ipso facto clauses can be unenforceable under national insolvency laws that often contain

71 ibid 18, 'multilateral netting: an arrangement among three or more parties for the netting of obligations and the settling of multilateral net settlement positions'.

72 Hudson (n 59) para 13–31.

73 For insolvency set-off in different jurisdictions and summary of insolvency set-off and netting availability worldwide, Philip R Wood, *Principles of International Insolvency* (2nd edition, Sweet and Maxwell 2007) 402–14, noting that the '[l]aw of set-off is of paramount importance in international financial affairs almost as important as the law of security interests' 408.

74 Schuyler K Henderson, 'Credit Risk and Swap Exposure' in Boris Antl, *Swap Financing Techniques* (Euromoney Publications Ltd 1983).

75 Tony Shea, 'The Usefulness of netting agreements' (1991) 6 J.I.B.L. 132.

76 Henderson (n 60) para 11.3.

anti-deprivation rules. Anti-deprivation essentially means that an unsecured creditor may not withdraw or remove, through contractually or otherwise, assets from an insolvency estate to the detriment of other unsecured creditors who have the equal right to payment, 'pari passu', to the same assets in proportion to their claim and creditor rank, 'pro rata'.[77] This is still a common approach. According to the Unidroit Principles, a soft-law instrument, an ipso facto clause should not conflict with equal treatment of creditors and it should not be used to avoid the effects of local insolvency laws.[78]

Novation netting means essentially that on the payment date, both payment obligations are discharged and replaced by a new single legal obligation on one party to pay the net balance to the other. Unlike in payment netting, novation netting of reciprocal obligations creates a legal obligation to perform a single payment to a counterparty. The Basel Committee made an early attempt to define netting by novation:

> [B]ilateral contract between two counterparties under which any obligation to each other to deliver a given currency on a given date is automatically amalgamated with all other obligations for the same currency and value date, legally substituting one single net amount for the previous gross obligations.[79]

While this definition serves the purpose of creating a single net amount, it was not adequate for bilateral OTC derivatives trading. First, novation netting would still require payments to be made on the same date and in the same currency, as in payment netting. This would go against the idea of cross-currency swaps, however, a common type of derivative structure in which the reciprocal payment obligations are not in the same currency.[80] In addition, novation under English law and New York law is a *three-party transaction*, not bilateral. In novation, a third-party takes the place of the replacing party, becomes directly liable towards the remaining party and obtains all rights of the replaced party.[81]

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77 Although seemingly simple concepts, the anti-deprivation rule and the *pari passu* rule and their interpretation has been one of the central questions in insolvency situations since the 18th century to recent years. P Niven, 'The Anti-Deprivation Rule and the Pari Passu Rule in Insolvency' (2017) 25 Insolv LJ 5, 6.

78 Principle 7(1)(c), Principle 7(1)(d) <https://www.unidroit.org/english/principles/netting/netting–principles2013-e.pdf>, accessed 1 June 2019.

79 For an early regulatory assessment, Basel Committee on Banking Supervision, 'International Convergence of Capital Measurement and Capital Standards' July 1988, Basel, 26, n 6, <https://www.bis.org/publ/bcbs04a.pdf> accessed 1 June 2019.

80 Shea (n 75) 314.

81 Henderson (n 60) para 11.3.

Novation netting would work in a multilateral trading, like in exchanges that clear trades centrally, where there are three-parties. In multilateral trading, novation would protect against the legal risk that insolvency laws would allow the liquidator of the insolvent counterparty to terminate those contracts favourable to the non-insolvent ('in-the-money' contracts) party and continue those contracts favourable to the insolvency estate (ie those under which the bankrupt party was 'in-the-money'). From a contractual point of view, the risk was that instead of treating the terminated transactions as a single payment obligation achieved through novation, each individual transaction would constitute an individual agreement that the bankruptcy administrator might 'cherry-pick'.[82]

> Consider that the parties had entered into a fixed-to-float interest rate swap under which Party A pays to Party B a fixed 5 per cent and Party B a floating rate to Party A. From the perspective of Party A and Party B, there is one transaction under a single agreement structure, but upon bankruptcy, from the perspective of national insolvency law, the transaction could be recharacterized as two separate agreements. If Party B is bankrupt, the liquidator could require Party A to pay the 5 per cent fixed amount to the bankruptcy estate of Party B whereas the liquidator could limit the payable floating rate amount (or even outright terminate) of Party B to pay the floating rate to Party A given that the liquidator is not supposed to make payments out of the bankruptcy estate as this reduce the amount available to other unsecured creditors.[83]

These inadequacies in novation netting would give rise to and the demand for mechanics of close-out netting, a legally enforceable ipso facto clause for bilateral OTC derivatives transactions. Unlike payment and novation netting, close-out netting concerns *obligations relating to future events* rather than past obligations. Payment netting might allow netting for specific currencies on a specific date for existing delivery obligations, but OTC derivatives transactions consist of future delivery obligations. Essentially, the idea was to innovate a mechanism that would allow the

82 Cunningham (n 7) 32. Kerr, 21. In the landmark English bankruptcy case on payment netting and novation netting *British Eagle International Air Lines Ltd. v. Campagnie Nationale Air France,* 1975 1W.L.R. 758, the House of Lords ruled that certain contractual netting arrangements leave certain transactions identifiable and therefore severable, and deemed that the *pari passu* had been violated and that this principle could not be 'contracted out' of' with ipso facto clauses. Following this ruling, market participants further developed the idea of close-out netting to reduce this legal risk. Edward Murray, 'Derivative Transactions' in Sarah Paterson, Rafal Zakrzewski (eds), *McKnight, Paterson and Zakrzewski on the Law of International Finance* (2nd edition, OUP 2017) 684–87.

83 Example taken from Mark J Roe, 'The Derivatives Market's Payment Priorities as Financial Crisis Accelerator' (2011) 63 Stanford Law Review 539, 570–71.

creation of one single net amount, the calculation of which would extend to cover all types of derivatives transactions entered into by the counterparties regardless of their form, maturity, and currency, and the future obligations thereunder.[84]

In close-out netting, the termination of all outstanding obligations upon insolvency would be achieved contractually by *acceleration*, i.e. by rendering all the transactions immediately payable, calculating the termination amount, and contractual termination of all derivatives contracts between the counterparties. Ideally, if a counterparty is placed into insolvency, the non-insolvent party could use close-out to avoid the risk of cherry picking or automatic stay and replace these terminated transactions with new transactions. Premature termination of a swap gave rise to complex payment and valuation calculations from early on.[85] Further, in addition to the risk of cherry picking, national bankruptcy laws generally contain provisions for automatic stay upon the commencement of bankruptcy proceedings. Automatic stay is effectively an injunction on the creditors of a bankruptcy estate not to exercise any of its contractual rights and remedies, including ipso facto clauses[86] To identify and possibly reduce such legal risks, the most rational measure for market participants was to obtain a legal opinion from a local legal expert and ask whether the local insolvency laws recognized close-out netting and the legal recognition of possible collateral the market participants might have put in place.[87]

Tthe ISDA MA sets the terms and conditions that regulate the procedure for bilateral close-out netting and the predetermined events that allow for the non-defaulting counterparty to exercise this right. These events are referred to as Event of Default upon which the other party may initiate the close-out netting procedure. In simplified terms, the latter consists of: (i) *acceleration* of payment and delivery obligations from the contractually agreed maturity of *all* of the transactions entered into under the ISDA MA; (ii) the *valuation* of each transaction (and their potential conversion to monetary equivalents to certain currency) by the non-defaulting party; and (iii) the *aggregation* to result in an overall net amount, i.e. determination of a single payment obligation through novation.[88] The amount of the remaining single payment obligation may be payable by either the non-defaulting or the defaulting party, depending on which party is 'in-the-money' or 'out-of-the-money'. Close-out netting does not only affect the position of the bilateral counterparties, but also

84 Shea (n 75) 314; Francesco C Nassetti, 'Basic elements in the maze of netting' (1995) J.I.B.L. 10(4) 145; For an analysis of the legal risk arising from the interpretation of 'executory contracts' and for related case law, Edward J Nalbantian, Peter S Smedresman, Tessa Hoser, 'Netting and Derivatives – A Practical Guide' (1993) 12 Int'l Fin. L. Rev, 38, 40; Henderson (n 12) 378–80.

85 James A Watkins, 'Legal Issues in Currency Swaps' (1982) 1 Int'l Fin. L. Rev. 26, 30.

86 Schuyler K Henderson, 'Credit Risk and Swap Exposure' in [Antl (n 74) 117.

87 Nina Hval, 'Credit Risk Reduction in the International Over-the-Counter Derivatives Market: Collateralizing the Net Exposure with Support Agreements' (1997) 31 Int'l L. 801, 819–20.

88 Marcel Peeters, 'On Close-out Netting' 3.10 in Thomas Keijser (ed), *Transnational Securities Law* (OUP 2014); UNCITRAL, The Principles on the Operation of Close-out Netting Provisions (2013) 32–33.

other creditors of the defaulting counterparty. A simplified example of close-out netting and its effect on other creditors can be drawn from an article by *Mark J Roe*:

> If the counterparty owes the bankrupt $100 million on one contract and is owed $100 million on another, the typical result, without netting, is that it must write a check to the bankrupt for $100 million, but it receives only a fractional return from the insolvent bankrupt. If the return to the bankrupt's creditors is only ten cents on the dollar, a no-netting scenario yields the counterparty a $90 million loss. Netting gets it that extra $90 million.[89]

5.4 THE LEGAL RISK OF NATIONAL INSOLVENCY LAWS

Legal uncertainty surrounding the enforceability of a close-out netting provision would depend on whether the national insolvency laws are liquidation-oriented, generally favouring the termination of obligations and the distribution of an insolvent party's assets, or reorganization-oriented which seeks to make insolvent party again a viable business through reorganization.[90] The recognition of close-out netting as a contractual right under English law derives from Rule 4.90 of the Insolvency Rules 1986, which stated:

> (1) This Rule applies where, before the company goes into liquidation there have been *mutual credits, mutual debts or other mutual dealings* between the company and any creditor of the company proving or claiming to prove for a debt in the liquidation.
>
> (2) An account shall be taken of what is due from each party to the other in respect of the mutual dealings, and *the sums due from one party shall be set off against the sums due from the other*. [...] (emphasis added)

In other words, although not without legal risks as to the valuation of the terminated transactions, Rule 4.90 recognized the idea of a single payment amount in insolvency situations and thus English law was receptive towards the use of ipso facto clauses.[91]

89 Mark J Roe, 'The Derivatives Market's Payment Priorities as Financial Crisis Accelerator' (2011) 63 Stanford Law Review 539, 570.

90 See the example in subchapter 4.2.

91 Shea (n 75) 133–34.

In contrast, in many civil law countries and also in the US, the recognition of contractual close-out netting arrangements upon insolvency required separate legislative acts.[92] Their respective bankruptcy laws may reflect a tendency towards reorganization rather than liquidation, which in turn reflects to the unenforceability of ipso facto clauses upon counterparty bankruptcy. If such a right to terminate upon counterparty insolvency applies, the non-defaulting counterparty cannot perform close-out netting, or this right can at least be put on hold, stayed, by the bankruptcy administrator.[93]

In the US, this recognition required amendments to the Bankruptcy Code, and especially to its Chapter 11, the aim of which is to allow for the rehabilitation of a company through reorganization, not its liquidation. The Bankruptcy Code includes an automatic stay provision which prevents the non-defaulting party from exercizing its contractual right to set-off.[94] Section 365 of the Bankruptcy Code[95] in turn could render ipso facto clauses unenforceable as well as potentially to allow the bankruptcy trustee to 'cherry pick' between contracts if the bankruptcy trustee would first be able to characterize the derivative contracts as 'executory contracts'. The legal character of an executory contract means that both parties have reciprocal obligations which both parties can either accept or reject. OTC derivatives generally include such reciprocal obligations since depending on market movements, each party to a transaction can be 'in-the-money' or 'out-of-money'. If the OTC derivative transaction would be executory regarding its legal form, this could be problematic from the non-defaulting party's perspective since it could leave the non-defaulting party with the obligation to perform its obligations to a bankruptcy estate on those transactions beneficial for the latter and unbeneficial for itself. On the other side of the argument, the collective interest of all the creditors should be maintained without exempting one type of unsecured creditor from the full application of insolvency laws, including mandatory stay and the right to maintain those contracts in force that are beneficial for this collective.[96]

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92 For a civil law analysis of a legal risk in the form of cherry picking, Bob Wessels, 'Close-out netting in the Netherlands' (1997) 12(5) J.I.B.L. 187, 189–91, noting that under certain circumstances, while the Dutch bankruptcy act generally could recognize close-out netting, some transfers might be recharacterized as fraudulent preference and thus be rendered unenforceable under Dutch law.

93 Jan Dalhuisen, *Dalhuisen on Transnational Comparative, Commercial, Financial and Trade Law Volume 3* (6th edition, Hart Publishing 2016) 309–312.

94 11 U.S. Code § 362 - Automatic stay,

(a) […] a petition filed under section 301, 302, or 303 of this title […] operates as a stay, applicable to all entities, of—

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor.

95 1 U.S. Code § 365 - Executory contracts and unexpired leases […] [t]he trustee, subject to the court's approval, may assume or reject any executory contract […].

96 Christoph Henkel, 'Harmonizing European Union Bank Resolution: Central Clearing of OTC Derivative Contracts Maintaining the Status Quo of Safe Harbors' (2013) 22 Transnat'l L. & Contemp. Probs. 81, 89–95.

According to many legal risk analyses, the recharacterization of OTC derivative transactions was a possible or even a likely scenario in light of not only the Bankruptcy Code but also the then existing US case law.[97] A 'safe-harbor' regime for bilateral OTC derivatives transactions, i.e. exemptions to the automatic stay and legal enforceability of close-out netting provisions, was enacted in 1990.[98] ISDA 'actively participated in the enactment of the 1990 amendments to the Bankruptcy Code'.[99] The appropriateness and even the legitimacy of these safe-harbours remain contested. The arguments against close-out netting are dicussed in subchapter 5.7.

5.5 INTERACTIONS BETWEEN TRANSNATIONAL LAW AND FINANCIAL REGULATION

The introduction of new products as well as the development of early master agreement structures did not go unnoticed by the Federal Reserve System and the Bank of England. In 1987, they announced a joint proposal for the calculation of risk weighting of certain specific types of swaps, as well as for an unspecified set of swaps.[100] It was the potential non-enforceability of ipso facto clauses that gave rise to legal uncertainty, especially under the Bankruptcy Code of the US. In addition, capital adequacy regulations, under which financial institutions are required to hold a certain set amount of own funds to meet their obligations to their creditors, did not recognise close-out netting as a credit risk reduction mechanism. For this reason, the risk weighting of swaps was high. This required financial institutions to

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97 Adam R Waldman, 'OTC Derivatives and Systemic Risk: Innovative Finance or the Dance into the Abyss' (1994) 43 Am. U.L. Rev. 1023, 1062–68, noting that automatic stay and the definition of 'executory contracts' gave rise to legal uncertainty; Nalbantian and others (n 84) 40; Schuyler K Henderson, 'Swap Credit Risk: A Multi-Perspective Analysis' (1988) 44 Bus. Law. 365, 378–80, summarising that if a contract is deemed to be an 'executory contract', it can be subject to cherry-picking by the bankruptcy administration or debtor in possession; Cunningham (n 7) 28.

98 Public law 101-311–June 25, 1990 104 Stat. 267, § 1, Sec. 103, limitation on avoiding powers.

(g) […] the trustee may not avoid a transfer under a swap agreement, made by or to a swap participant, in connection with a swap agreement and that is made before the commencement of the case […];

§ 560. Contractual right to terminate a swap agreement

The exercise of any contractual right of any swap participant to cause the termination of a swap agreement because of a condition of the kind specified in section 365(e)(1) of this title or to offset or net out any termination values or payment amounts arising under or in connection with any swap agreement shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title. […]; Lynn (n 34) 291, 332–33, 334–35; Nalbantian and others (n 84) 40.

99 Memorandum of Law of International Swaps and Derivatives Association, Inc. Securities Industry Association, and the Bond Market Association, March 17, 2004, 4, as Amicus Curiae in Support of Dismissal of Adversary Proceedings, in re Enron Corp. (Plaintiff) v. Lehman Brothers Finance S.A., et al., (Defendants), Case No. 01–16034 (AJG), Adv. No. 03–93383 (Amicus Curiae) <https://www.isda.org/a/ftiDE/exhibit-amicus-brief.pdf> accessed 1 June 2019.

100 Federal Register / Vol. 52, No. 56 / 3–24, 1987, 9304.

hold regulatory equity capital calculated on a gross basis for swaps, which reflect the actual net risk of these products.[101]

Regulators did recognise novation netting, however, given that novation netting was about calculating past rather than future obligations, it was of limited use to market participants in the OTC derivatives market. In this market, the calculation was about future obligations and their valuation.[102] Absent regulatory recognition of close-out netting, swaps would cost more than they would otherwise cost, and the banks would pass these additional costs on to clients.[103]

Public officials saw the recognition of close-out netting also as a competitiveness issue in the domestic banking industry in the US and England generally, and especially for larger financial institutions already engaging in large-scale derivatives trading. One solution was to make the 'large, sophisticated banking organizations' subject to more intrusive regulations, since they had the financial means and capability to comply with more complex regulatory requirements.[104] The Federal Reserve System and the Bank of England concluded that the industry efforts to create a single agreement structure under which multiple types of derivatives with the same counterparty could be consolidated, would be a welcome development. However, the financial industry had to meet two requirements to obtain regulatory recognition.[105]

> The US regulatory authorities and the Bank of England recognize that such arrangements [single master agreement and aggregation of transactions] may in certain circumstances reduce credit risk and wish to encourage their further development and implementation. If market participants were to develop such standardized master agreements with general, market-wide application, and if there were unambiguous legal opinions that such agreements reduce credit risk and would be recognized by the relevant judicial authorities, the proposal might be modified to treat multiple contracts with a single counterparty that were created within the terms of such a master agreement as a single net contract.[106]

101 William D Kerr, 'UK/US Proposal on Swap Capital Requirements' (1987) 6 Int'l Fin. L. Rev. 19, 20–21.

102 Dermot Turing, 'Set-off and netting: developments in 1993 affecting banks' (1994) 9(4) J.I.B.L 138, 139.

103 Kerr (n 101) 22–23. The calculation of the capital cost would to a large degree depend on financial benchmarking and the so-called mark-to-market valuation that determines, among other issues, the exposure of a counterparty towards its counterparty on a certain date.

104 Federal Register (1987) 9307–08 discussing *de minimis* rules for certain market participants.

105 ibid. By 1989, ISDA 'now composed of more than 100 major financial institutions', Henderson (n 12) 373.

106 Federal Register (1987) 9312 (c).

From the industry perspective, the first requirement was not seen as problematic given that at least ISDA had recently standardized and published a contract type that should meet this requirement.[107] As to the second requirement of obtaining unambiguous legal opinions, the situation was more challenging since the enforceability of the netting provisions of the master agreement would often depend on the bankruptcy laws applicable to the counterparty and the laws of many jurisdictions. From the perspective of market participants, especially the 1978 US Bankruptcy Code was unclear in this respect. Given that the OTC derivatives market was growing rapidly, the recognition of contractual netting clauses was also becoming a public policy concern.[108] The prevention of cherry picking, and the enforceability of ipso facto clauses and other legal risks turned from a legal risk into a public policy issue from a regulatory perspective. Both transnational financial institutions and regulators now shared a common objective.

In order for market participants be able to report their derivatives transactions on a net rather than gross basis to regulators, set-off arrangements had to be contractually in place, and the enforceability of these contractual arrangements had to be ascertained with third party legal opinions used then as evidence for regulators as to their enforceability.[109] The risk that a liquidator could overturn a close-out clause was assumedly quite evident. Regardless of the legal risk, market participants included close-out netting clauses to their contracts. The effectiveness of close-out clauses had not been 'tested', i.e. no such bankruptcy case had occurred where the liquidator would have interpreted the Bankruptcy Code in a manner that would allow it to cherry pick transactions. In addition, no court had given its legal interpretation of such a decision by 1989. The legal opinions in this regard were unreliable. However, the Basel Committee did not:

> [w]ish to discourage market participants from employing clauses which might well afford protection in certain circumstances in some national jurisdictions and [the Basel Committee] would be prepared to reverse its conclusion [on the legal uncertainty] if subsequent decisions in the courts support the integrity of close-out netting agreements.[110]

107 Kerr (n 101) 21.

108 Kerr (n 101) 21.

109 Turing (n 102) 139, noting that following a notice by the Bank of England in December 1993, market participants were required to obtain third party legal opinions as to the enforceability of netting arrangements, and also describing the legal risks arising from English law regarding the enforceability of close-out netting.

110 Basel Committee on Banking Supervision, 'International Convergence of Capital Measurement and Capital Standards' July 1988, 27 <https://www.bis.org/publ/bcbs04a.pdf> accessed 1 June 2019.

The legal uncertainty arising already from the US let alone the insolvency laws of other nations regarding close-out netting was also reflected in the legal opinions to which practitioners had to leave many qualifications. For simple transactions involving counterparties in a single jurisdiction and who were using a master agreement to document their transactions could obtain legal opinions with less qualifications. In contrast, cross-border transactions with bespoke products would mean increased legal risk arising from national laws which in turn would mean that legal opinions were more ambiguous and thus harder for regulators to accept.[111]

ISDA standardized a customized legal opinion that could be requested from and provided by local councils in relation to the enforceability of contractual bilateral netting under different national laws. However, given the legal uncertainty arising from national legal systems, both legislation and case law, BIS did not consider these opinions to satisfy the requirement set out earlier.[112] Perhaps having reached the same conclusion as BIS, ISDA had promoted and lobbied simultaneously amendments to the US Bankruptcy Code, the purpose of which was to ensure the legal recognition of close-out netting clauses without the risk of automatic stay or cherry-picking, save for cases of fraud.[113] The lobbying efforts of ISDA extended also to authorities outside the US with the intent of getting the netting arrangements recognized in foreign bankruptcy laws. The US Congress did include these amendments to the Bankruptcy Code in 1990 that were a continuation to earlier amendments made in 1982 and 1984.[114] However, the amendments to legislation did not prevent legal uncertainties arising from case law. US courts might reach different conclusions about the content of the amended laws. [115]

It was noted early on that market participants could, with relative ease, benefit from the inadequacies of tax regimes unable to identify the nature of interest rate swaps which could be tailored to an economic and legal form that rendered tax laws inapplicable to such products.[116] Once the OTC derivatives markets grew, so did the regulatory attention by international regulators such as the Basel Committee[117] and the International Organization of Securities Commissioners, the G7 summit,

111 Nalbantian and others (n 84) 40–41, also predicting that the recognition of close-out netting might be achievable, at least for the simpler type of derivatives under the national laws of the G-12.

112 Henderson (n 12) 396–97.

113 Henderson (n 12) 365, 397.

114 Anatoli Kuprianov, 'Over-the-Counter Interest Rate Derivatives' (1993) 79(3) Federal Reserve Bank of Richmond Economic Quarterly 65, 88–89. For a detailed list of these and other US legislative amendments made, Amicus Curiae (n 99).

115 Johnson (n 58) 65–76.

116 Eugene Y Ferrer, 'Tax Treatment of Interest Rate Swaps at Disposal: Should Swap Participants Have Their Cake and Eat it Too?' (1992) 26 U.S.F. L. Rev. 283.

117 Bank for International Settlements '62nd Annual Report' Basel, 15th June, 1992, 182–4, <https://www.bis.org/publ/arpdf/archive/ar1992_en.pdf> accessed 1 June 2019.

and the Group of Thirty, only to name few.[118] Existing financial regulation was also deemed, in many respects, inadequate from the outset in responding to the market development. For example, the capital adequacy rules introduced under the 1988 Basel Accord were welcomed by market participants. The 1988 Basel Accord (Basel I) required no market participants to hold more capital as was seen necessary to cover the credit risk of simpler 'vanilla' products. This, however, was not the case in more complex or exotic derivatives that did not even exist, or became popular after the entry into force of Basel I. Furthermore, the process of changing the Basel I rules was deemed slow and overtly legalistic as the process involved at least twelve governments. The classification-based rules of Basel I were seen to reflect a 'simpler, more static financial era' and not the reality of the era of increasingly institutionalized and complex financial innovation.[119]

Against the background of financial innovation and at least to some degree capital adequacy rules unfit to give answers as to the capital treatment of new derivatives products, it might not come as a surprise that capital adequacy arbitrage became a part of the business. The legal form outweighed the actual economic substance of products both under Basel I and the EC capital adequacy rules[120] that were largely based on the former.[121] Calls for more regulation in the derivatives market were common, but these concerns were criticized for being imprecise, and that they allegedly lacked a systematic and candid approach to the issue.[122]

As outlined by *Henry TC Hu* in 1989, the creation of a master agreement architecture would be beneficial, as such contract architecture could cover all transactions, often standardized, entered into by two market participants. This would save time and effort and the parties of the agreement could focus their negotiation efforts to those terms and conditions relevant for individual transactions. Separate, short confirmation that would include only the basic economic and legal terms of a given transaction could suffice in this regard.[123] Hu also noted that the emergence of new type of financial products may be difficult to regulate if the underlying processes leading to their creation are unknown, as well as how legalistic approach with classification-based rules to financial products will aggravate this

118 RH Weber, 'New Governance, Financial Regulation, and Challenges to Legitimacy: The Example of the Internal Models Approach to Capital Adequacy' (2010) 63 Admin. L. Rev. 783.

119 Henry TC Hu, 'Swaps, the Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm' (1989) 138 U. Pa. L. Rev. 393–94, 415, 435.

120 Council Directive of 18 December 1989 on a Solvency Ratio 89/647/EEC for Credit Institutions, OJ L386, Council Directive 93/6/EEC of March 15, 1993, [1993] O.J. L141/1.

121 Paul Goris, 'Creative accounting and capital adequacy: the swap-loan dilemma' (1994) 9 J.I.B.L., 150, 152, acknowledging the risk that, if regulated more heavily than elsewhere, market participants might relocate their swap transactions to other jurisdictions with a less stringent capital adequacy regime, 152–57.

122 Drew E Macintyre, 'Financial innovation and regulatory trepidation: swaps and the OSC' (1995) 25 CBLJ 163; Cunningham (n 7) 33.

123 Hu (n 119) 430–31.

problem, and that some market participants can use this situation to their benefit whereas some cannot.[124] In short, the issue was that the Basel Accord would lead to regulatory mispricing as new derivative products had to be fitted into existing regulatory categories that did not reflect the actual risk these products posed [125]

5.6 FROM REGULATORY RECOGNITION TO REGULATORY REQUIREMENT

5.6.1 INTERACTIONS BETWEEN ISDA AND THE BASEL COMMITTEE

In the late 1980s, ISDAs role also extended from contractual drafting for new products to interactions with international organizations, namely the Basel Committee.[126] These efforts were directed especially towards the regulatory recognition of close-out netting.[127] In the EU, this came as part of the agenda in a larger regulatory process known as the Lamfalussy process discussed below in more detail. In 1989, BIS published a detailed study known as the Angell Report prepared by a group of experts from the central banks of the G-10 countries.[128] The purpose of the study was to identify the possible benefits of netting arrangements, both in bilateral and multilateral clearing. As a word of caution, and as noted by *Christian Chamorro-Courtland,* many scholars use the terms 'clearing' and 'settlement' in an inconsistent manner which leads to confusion and legal uncertainty.[129]

124 Hu (n 119) 392–94.

125 Hu notes that the challenges already identified in his 1989 article remain persistent in current financial regulation. Henry TC Hu, 'Systemic Risk and Financial Innovation – Toward a "Unified" Approach' in Joseph G Haubrich, Andrew W Lo (ed), *Quantifying systemic risk* (University of Chicago Press 2013) 15. The regulatory 'cubbyhole' technique was used already in 1988 in 'the international response to the systemic risks posed by the derivatives revolution', 13. The technique involves the updating of existing classifications of products. A related issue is the 'regulatory paradigm' that includes the problem of 'extraordinary informational asymmetry between regulators and derivatives dealers' meaning that the latter generally know more than the former of what is taking place in the market, 15.

126 Capital requirements were unbalanced as they applied to commercial banks but not to market participants operating outside central bank supervision echoing the early rise of shadow banking (discussed in subchapters 2.11.3. and 2.11.4), Gallant (n 7) 151–52; Cunningham (n 7) 33; BIS, Recent Developments in International Interbank Relations, Basel, October 1992, 23–25 <https://www.bis.org/publ/ecsc02.pdf> accessed 1 June 2019; Basel Committee, Consultative proposal by the Basel Committee on Banking Supervision, Supervisory Recognition of Netting for Capital Adequacy Purposes, April 1993 <https://www.bis.org/publ/bcbs11c.pdf> accessed 1 June 2019.

127 George Crawford, Bidyut Sen, *Derivatives for Decision Makers: Strategic Management Issues*, 129 (John Wiley & Sons, Inc.1996), noting also how the '[u]niversal recognition of netting agreements would do much to reduce systemic risk in the international financial community'; Christopher L Culp, 'Functional and Institutional Interaction, Regulatory Uncertainty, and the Economics of Derivatives Regulation' 458, 476–78, in Robert J Schwartz, Clifford W Smith (eds), *Derivatives Handbook: Risk Management and Control* (John Wiley & Sons, Inc. 1997) noting ISDAs 'tremendous efforts to secure the netting provisions' in the relevant US legislation.

128 BIS, 'Report on Netting Schemes' February 1989 <https://www.bis.org/cpmi/publ/d02.pdf> accessed 1 June 2019.

129 Christian Chamorro-Courtland, 'Central counterparties (CCP) and the new transnational lex mercatoria' (2011) 10 Fla. St. U. Bus. Rev. 57, 62.

While acknowledging the benefits, the Angell Report also identified risks in that in some cases-netting arrangements could obscure the actual allocation of risks especially in cross-border settings.[130] In its analysis, the Angell Report assumed that netting agreements are legally valid and enforceable, and concluded that if they are not, the 'credit and liquidity risks can be much larger than otherwise believed'.[131] Further, the Angell Report noted that local national laws are the source of legal risk for contractual set-off arrangements.[132] In 1990, BIS published its report, known as the Lamfalussy Report,[133] which introduced six standards for netting schemes and principles for cooperative central-bank oversight of multilateral netting in clearing facilities. According to the Lamfalussy Report, which confirmed the view expressed in the Angell report, netting schemes are useful in reducing credit and liquidity exposures in the market, but only if they are legally enforceable, or 'have sound legal basis',[134] and noted 'the development of truly trans-national interbank settlement arrangements' which technological advancement had made possible.[135]

Furthermore, the Lamfalussy Report recognized the necessity of a 'properly-prepared written netting agreement' in securing the benefits of netting.[136] In the same connection, the Lamfalussy Report concluded that such legal preparation will need to be thoroughly delivered by the market participants and netting scheme providers, but admits that such requirements might not be possible in all instances.[137] In light of these findings, the Lamfalussy Report concluded that given the difficult choice-of-law and conflict-of-law questions, netting benefits can only be achieved through harmonization of national laws.[138]

130 BIS (n 128) 2.3–2.4, n 880.

131 BIS (n 128) 2.6, 2.7, noting also the advancement in information technology and its positive impact in reducing credit risk or liquidity risk, 4.5.

132 BIS (n 128) 5.9.

133 BIS, 'Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries' Basel, November 1990, <https://www.bis.org/cpmi/publ/d04.pdf> accessed 1 June 2019. The Lamfalussy Report was part of a larger public policy initiative known as a Lamfalussy Process that was to support the regulatory initiative of the EU, the Financial Services Action Plan (FSAP), that served as the start for many directives and regulations aimed at creating a single market in financial services in Europe by 2005. Matthias Haentjens, Pierre de Gioia-Carabellese, *European Banking and Financial Law* (Routledge 2015) 10–15; Nathalie Aubry, Michael McKee, 'MiFID: where did it come from, where is it taking us?' (2007) 22 J.I.B.L.R. 177; the outcome of FSAP was that '*Significant elements of the vast regulatory machinery of the Financial Services Action Plan are in practice already being avoided*' (emphasis added); Joanna Benjamin, David Rouch, 'The international financial markets as a source of global law: the privatisation of rule-making?' (2008) 2 Law & Fin. Mkt. Rev. 78, 79.

134 The Lamfalussy Report (n 133) 2.23.

135 The Lamfalussy Report (n 133) 2.9.

136 The Lamfalussy Report (n 133) 2.24.

137 The Lamfalussy Report (n 133) 2.26.

138 The Lamfalussy Report (n 133) 2.27.

5.6.2 INDUSTRY RECOMMENDATIONS ON CLOSE-OUT NETTING

The financial industry sponsored and published public-policy recommendations and market research regarding derivatives trading. Maybe the most well-known of these were the reports published by an industry group known as the Group of Thirty, a group consisting of major dealer banks, consultancies, and law firms. The first report particularly relevant for the purposes of this research is titled 'Derivatives: Practice and Principles'[139] (the First Report), which included a set of 20 recommendations for the development of the derivatives industry. Of these recommendations, the First Report published in 1993 'recommends four ways that supervisors and regulators, for their part, can help the financial infrastructure keep up with derivatives activity'.[140] The recommendations addressed problems associated with the non-recognition of bilateral and multilateral netting, especially in the calculation of the capital adequacy of banks. The First Report noted that '[s]ignificant efforts have been made to develop standard master agreements that effect netting across the full range of derivatives products' reflecting the requirement set earlier by regulators.[141]

Following this development, the First Report concluded that regulators, national financial supervisors represented on the Basel Committee, 'should recognize and implement bilateral close-out netting for capital purposes'.[142] The First Report also addressed the issue of legal risk arising from national legislation in terms of enforceability of netting in bankruptcies, the overall enforceability of derivatives agreements, and the corporate capacity issues of different entities. The recommendation for regulators was to identify and prevent a situation where national legal systems, allegedly unable to meet the market demand for a certain type of legislation, would be a source of legal risks for derivatives trading and for financial development in general.[143] Recommendation 22 urged legislators, regulators, and supervisors, including central banks, to 'work in concert with dealers and end-users to identify and remove any remaining legal and regulatory uncertainties with respect to' ultra vires risk, enforceability of contracts, bilateral close-out netting, and collateral arrangements in bankruptcy.[144]

The second report titled 'Derivatives: Practices and Principles - Follow-up Surveys of Industry Practice'[145] (the Second Report) was published by the Group of Thirty

139 Global Derivatives Study Group (n 19).

140 Global Derivatives Study Group (n 19) 3.

141 Global Derivatives Study Group (n 19) 20.

142 Global Derivatives Study Group (n 19) 20.

143 Global Derivatives Study Group (n 19) 21, also referring to the English court case Hazell v Hammersmith and Fulham LBC [1992] 2 AC 1, 49, further analysed in this research in chapter 4.3.2.

144 Global Derivatives Study Group (n 19) 21.

145 Global Derivatives Study Group, 'Derivatives: Practices and Principles – Follow-up Surveys of Industry Practice' December 1994 (Global Derivatives Study Group 1994) < http://group30.org/images/uploads/publications/G30_Derivatives–Surveys.pdf > accessed 1 June 2019.

in 1994. The surveys were sent to roughly 900 firms, of which about two thirds were end-users and one third dealers, in the parlance of this research transnational financial institutions and transnational corporations, respectively.[146] The Second Report consisted of policy recommendations for both dealer financial institutions as well as for end-users followed by a questionnaire relating to the same. Without other evidence, the Second Report casts light on the prevalence and adoption of master agreement structure in the OTC derivatives industry. Recommendation 13 (Master Agreements) addressed to dealers suggested the adoption of one master agreement per counterparty for multiple types of derivative products which would allow payment netting and close-out netting.[147] Of all categories of dealer respondents, in aggregate across all size categories, over 95 per cent responded that the recommendation applies to their respective business operations[148] and the dealer market had witnessed a clear increase in the gross replacement cost documented under a master agreement structure over a period of 12 months.[149] Interest rate and currency derivatives were commonly used under one master agreement, whereas FX forwards and options were not.[150]

New product types could be attached to the existing master-agreement architecture through the introduction of standardized product definition booklets. Market participants were able to incorporate the new definitions to their existing master agreements by making a simple reference to an existing master agreement in a separately published Definitions booklet. This technique, in turn, allowed market participants to introduce new product categories while enjoying the benefits of a master agreement structure especially in relation to close-out netting and regulatory recognition in terms of capital adequacy requirements. Regarding the questions addressed towards end-users, the Second Report put forward the same recommendation 13 (Master Agreements) for the wide adoption of one master agreement with each counterparty for multiple types of derivative products which would allow bilateral payment netting and close-out netting.[151] Of all the end-user categories, in aggregate, approximately 86 per cent responded that the recommendation applies to their respective business operations.[152] The OTC markets became organized and managed by transnational financial institutions and transnational corporations. Using one particular market as an example of a wider

146 It is worth noting that the response rate was perhaps somewhat low: 125 dealers and 149 end-users responded.

147 Global Derivatives Study Group 1994 (n 145) 66

148 Global Derivatives Study Group 1994 (n 145) 66, Question 13.1.

149 Global Derivatives Study Group 1944 (n 145) Question 13.6.

150 Global Derivatives Study Group 1994 (n 145) 66, Question 13.4.

151 Global Derivatives Study Group 1994 (n 145) 214.

152 Global Derivatives Study Group 1994 (n 145) 214, Question 13.1.

phenomenon, 'the major dealers establish the rules of the CDS market and for all practical purposes regulate it'.[153]

Later on, close-out netting and legal enforceability of financial collateral arrangements became recognized also in international treaties, recommendations, and principles. Chapter V of the 2009 Geneva Securities Convention on substantive law explicitly recognizes close-out netting (Article 31), title transfer collateral agreements (Article 32) and the legal enforceability of these rights and arrangements (Article 33).[154] The 2004 UNCITRAL Legislative Guide on Insolvency Law (the Guide) recognizes the importance of close-out netting in mitigating systemic risk and provides an example scenario in which the lack of close-out netting could result in a cascade of defaults and potential financial distress on a systemic scale. The Guide notes that there are nations with bankruptcy laws that do not recognize or limit close-out netting, how national bankruptcy laws can be strategically misused, and includes a policy recommendation not only as to its explicit recognition but also broad drafting of insolvency law provisions that would allow for the contractual automatic termination and close-out upon the commencement of insolvency proceedings.[155]

5.6.3 UNIDROIT PRINCIPLES ON CLOSE-OUT NETTING

In 2013, UNIDROIT, a public international organization that ISDA sought to lobby 'in order to fortify the favourable private and insolvency law treatment of close-out netting',[156] went further in its efforts to promote the recognition of close-out netting through the introduction of The Principles on the Operation of Close-Out Netting Provisions.[157] These Principles provided explanations and commentaries for each of the eight principles aimed at national legislators and policy-makers not as a binding legal instrument but as a recommendation. Interestingly, the Principles states that close-out netting is 'not particularly well-defined' and uses a functional understanding of the term, under which the result of a single payment

153 Schuyler K Henderson, 'Credit derivatives and operational risk, or why a credit default swap is not like a bond' (2007) 1 Law & Fin. Mkt. Rev. 31.

154 Unidroit Convention on Substantive Rules for Intermediated Securities < https://www.unidroit.org/instruments/capital-markets/geneva-convention> accessed 1 June 2019; the purpose of this agreement generally referred to as the Geneva Convention is to facilitate international trade through compatibility and convergence of different rules on intermediated securities, Roy Goode, Herbert Kronke, Ewan McKendrick, *Transnational Commercial Law, Texts, Cases and Materials* (2nd edition, OUP 2015) paras 15.18–15.43.

155 UNCITRAL Legislative Guide on Insolvency Law, United Nations, Recommendation 100, New York, 2005, 156–58 < https://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf> accessed 1 June 2019.

156 Roy Goode and others (n 154) para 15.75

157 UNCITRAL (n 155).

obligation is key, rather than attaching the definition to any existing legislative or regulatory instrument. In other words, the functional approach allows for different definitions and even methods under different jurisdictions and contracts as long as it achieves a certain result, a single payment obligation. The Principles also note that the understanding of the concept differs significantly as to its scope and legal effects in different jurisdictions. Among other risks, close-out netting could potentially be recharacterized as a common type of set-off under national laws.[158]

Principle 7 is the most central for close-out netting, recommending that national laws should not allow for mandatory stay, cherry-picking, or consider it as preferential treatment of creditors, and promoting the recognition of contractual close-out provisions.[159] Many scholars and policy makers about the benefits of close-out netting but there are also considerable arguments against it which are discussed in Chapter 5.7. Even with the prevailing legal uncertainty in some jurisdictions,[160] close-out netting has by and large become enforceable in all EU Member States. Close-out netting and its recognition by policymakers in different jurisdictions was, and is seen as, an elemental part in reducing credit risk and systemic risk in financial markets. At least for such reasons, the industry representatives stress that any public deviation from, or intervention to, close-out netting should be used sparingly and crafted carefully.[161] The Financial Stability Board, a transgovernmental organization, has introduced its own set of principles on close-out netting addressed specifically towards financial institution resolution. The UNIDROIT Principles are designed to apply to insolvencies in general and, while they are similar, there are other differences between them as well.[162]

5.6.4 CLOSE-OUT NETTING POST GFC: THE RESOLUTION STAY

One of the new regulatory powers introduced after the GFC is the right given to resolution authorities to impose a temporary stay on bilateral close-out netting when they take resolution measures against a large financial institution in financial trouble. Essentially, in the post GFC regulatory environment, it is financial regulation

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158 UNCITRAL (n 155) 2, 6, 19, Principle 2 Preamble. The functional approach acknowledges that close-out provision can be a part of a standard master documentation, of a tailor-made framework agreement, or an entirely separate and self-standing agreement, 21.

159 UNCITRAL (n 155) 7; Stephanie Loizou, 'Close-out netting and an introduction to the UNIDROIT principles on its enforceability' (2012) 27 J.I.B.L.R. 429, 432.

160 For the remaining legal uncertainties, Matthias Haentjens, Perre De Gioia-Carabellese, *European Banking and Financial Law* (Routledge 2015) 203–04, n 33.

161 For an industry view, David Mengle, 'The Importance of Close-out Netting' ISDA Research Notes, number 1, 2010, <https://www.isda.org/a/USiDE/netting-isdaresearchnotes-1-2010.pdf> accessed 1 June 2019.

162 Edward J Janger, 'Treatment of Financial Contracts in Bankruptcy and Bank Resolution' (2015–2016) 10 Brook. J. Cor. Fin. & Com. L. 1, 8.

that sets the criteria for the terms and conditions that a master agreement must contain. While it is not possible to analyze resolution powers in any detail, given the volume of regulations alone, the existence of this power is an important example of the interaction between transnational law and transgovernmental regulation as evidenced by the innovations made to the ISDA Master Agreement structure.

Resolution stay powers originate from the Financial Stability Board (a transgovernmental organization discussed in Chapter 6) that introduced Key Attributes of Effective Resolution Regimes for Financial Institutions (Key Attributes) in 2014. [163] Regarding the treatment of netting in insolvency, the Key Attributes in turn follow the views adopted in the US. [164] The purpose of resolution stay is to prevent the termination of financial contracts for a short period of time if regulators place a larger financial institution into resolution or take other interventionary measures. For example, if a large financial institution is placed into resolution, and its counterparties terminate their respective financial contracts under their market standard financial contracts, there is a risk of both contagion, one too-big-to-fail might drag down its direct counterparties to default, and after close-out, there might be little left of the financial institution and thus little reason for resolution measures. [165]

The Key Attributes aim for continuity of the business of failing financial institutions rather than their dissolution. The resolution stay is limited in that that it is aimed only to prevent the use of contractual termination rights for a short period of time without interfering with the underlying obligations. Payment and delivery obligations remain in force during the resolution stay between the financial institution that is subject to the resolution measures and its counterparties. If an actual default occurs, resolution stay does not qualify as such, and the counterparties are allowed to terminate their respective contracts.[166] In other words, contractual close-out netting rights are preserved under the Key Attributes, but their use is stayed for a short period under which resolution authorities are to figure out a solution to the problem of the failing financial institution. If the solution works, the only deviation for market participants is that their contractual rights to terminate and close-out were stayed for a short period time.[167]

163 Financial Stability Board, 'Key Attributes of Effective Resolution Regimes for Financial Institutions', I-Annex 5: Temporary stay on early termination rights 15 October 2014 <http://www.fsb.org/wp-content/uploads/r_141015.pdf> accessed 1 June 2019.

164 Janger (n 162) 7.

165 ibid 4–5.

166 FSB (n 163) 51–53.

167 Janger (n 162) 7.

In the EU, the Key Attributes were introduced in the Bank Recovery and Resolution Directive (BRRD).[168] Under Article 32(1) of BRRD, resolution authorities can take a resolution action if three conditions are met. In summary, these conditions are that: 1) an authority has determined that an institution is failing or is likely to fail; 2) private sector measures or other public measures than resolutions would not be enough to correct the problem; and 3) the resolution measure is in the public interest.[169] There has been great discrepancy in the implementation of the Key Attributes across jurisdictions. The use of resolution stays raises questions on extraterritorial enforceability of such resolution measures meaning that a resolution decision made in one jurisdiction might not be recgonized in others.[170]

Followed by discussions between regulators and ISDA, ISDA introduced a market solution in the form of a protocol under its ISDA MA architecture, the 2014 ISDA Resolution Stay Protocol. Protocols are an importan feature of the ISDA MA architecture and a form of private regulatory mechanism. Through protocols, ISDA MA architecture can be voluntarily amended across multiple counterparties. Protocols are essentially a multilateral contractual amendment mechanism to which ISDA MA users may adhere to within a set period of time. If they adhere to a protocol, market participants are then to bilaterally amend their existing contract documentation as to comply with the obligations set in the Protocol.[171] The adherents to the protocol agreed to amend their existing ISDA Master Agreements to contractually recognize the cross-border application of resolution stays.[172] While technically voluntary, it is possible that adherence to the 2014 ISDA Resolution Stay Protocol was due to a 'trickle-down' of pressure first from FSB to local regulators, and from there, from local regulators to the financial instutions under their supervision.[173]

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168 Parliament and Council Directive 2014/59/EU, Establishing a Framework for the Recovery of Credit Institutions and Investment Firms, 2014 O.J. (L 173) 190, Article 71(1):

Power to temporarily suspend termination rights

1. Member States shall ensure that resolution authorities have the power to suspend the termination rights of any party to a contract with an institution under resolution from the publication of the notice pursuant to Article 83(4) until midnight in the Member State of the resolution authority of the institution under resolution at the end of the business day following that publication, provided that the payment and delivery obligations and the provision of collateral continue to be performed.

169 BRRD (n 168) Article 32.

170 Traci Biedermann, 'Cross-border resolution recognition: EU legislation staying default rights as a model for the United States' (2016) 23 Colum. J. Eur. L. 177, 181.

171 Moorad Choudhry, *Structured Credit Products: Credit Derivatives and Synthetic Securitisation* (2nd edition, John Wiley & Sons, Inc 2010) 133–34.

172 ibid 182; Janger (n 162) 10; the 2014 ISDA Resolution Stay Protocol was replaced by ISDA 2015 Universal Resolution Stay Protocol in 2015 <https://www.isda.org/protocol/isda-2015-universal-resolution-stay-protocol/> accessed 1 June 2019.

173 Biedermann (n 170).

5.7 BILATERAL CLOSE-OUT NETTING AND PATH DEPENDENCE

The legitimacy and appropriateness of the insovelncy safe-harbours discussed above remains contested by many.[174] Bilateral close-out netting is criticized as it can excessively externalize risk to third parties and the financial system as a whole:

> As between it and the debtor, this [close-out netting] result is fair. But as between the counterparty and the debtor's other creditors it may not be. [...] The local attractiveness of derivatives netting among financially central firms is partly due to this risk transfer away from the firm and its creditors, to the United States. [175]

Essentially, the argument is that close-out netting is actually a source of systemic risk instead of a method that reduces it. Close-out netting is claimed to: lack transparency as third parties cannot know about the contractual arrangements of others; lack consistency as it leaves too wide a margin of discretion for non-defaulting parties regarding whether to terminate the contractual arrangements or not; and erode equality as it allegedly favours larger counterparties over their smaller counterparts.[176] Close-out netting has also been said to result in unnecessary risks in the financial system, in that it allows for greater leverage, increases market volatility, serves as a redistribution mechanism of risk, leads to weak lending standards, and propagates systemic shocks.[177] Market volatility is something that close-out netting does not necessarily protect against as there is a risk that in market turbulence it is the inability to meet margin calls in a market situation where the cost of collateral is higher due to increased demand that can lead to bankruptcies.[178] *Darrell Duffie* and *David A Skeel Jr* have summarized the costs, as well as the benefits not covered here, of safe harbours to include lower incentives for counterparties to monitor their counterparties, incentive to benefit from too-big-to-fail status, substitution of

174 Peeters (n 88) paras. 3.45–3.50; Peter Marchetti, 'Amending the flaws in the safe harbors of the bankruptcy code: guarding against systemic risk in the financial markets and adding stability to the system' (2014–2015) 31 Emory Bankr. Dev. J. 305, 334–38. For analysis of the applicability of safe harbour regimes after the GFC under the US and English laws, ibid 340–73.

175 Mark J Roe, 'The Derivatives Market's Payment Priorities as Financial Crisis Accelerator' (2011) 63 Stanford Law Review 539, 570.

176 Vincent R Johnson, 'International Financial Law: The Case Against Close-out Netting' (2015) 33 B.U.Int'l L.J., 101, 116–125 <https://ssrn.com/abstract=2891907> accessed 1 June 2019; Peeters (n 88) paras 3.45–3.50.

177 Rizwaan Jameel Mokal, 'Liquidity, systemic risk, and the bankruptcy treatment of financial contracts' (2015–2016) 10 Brook. J. Corp. Fin. & Com. L. 15, 59–62.

178 Adrian Blundell-Wignall, Paul E Atkinson, 'Deleveraging, Traditional versus Capital Markets Banking and the Urgent need to Separate and Recapitalise G-SIFI Banks', OECD Journal: Financial Market Trends, Volume 2012, Issue 1 <https://www.oecd.org/finance/financial-markets/Deleveraging,%20Traditional%20versus%20Capital%20Markets%20Banking.pdf> accessed 1 June 2019.

one type of financing with other forms of financing, the risk of collateral fire sales, and an incentive for distressed companies to not file for bankruptcy in a timely manner.[179] Trading under a master agreement also creates significant incentives for end-users to trade with the same dealer. This 'lock-in effect' means that the more there are transactions with a single dealer, the larger the benefits of netting, setoff, and margin. Conversely, transacting with one dealer instead of many runs the risk of concentration.[180]

Steven L Schwartz and *Ori Sharon* suggest that the amendment made to the US Bankruptcy Code in 1978 was, at least partially, the starting point of path dependence.[181] To summarize the argument, one original argument backed with little evidence from a derivatives industry lobbyist resulted in narrow exemptions, which in time led to further industry-lobbied legislative amendments for the recognition of ipso facto clauses and close-out netting in the US Bankruptcy Code. Without proper justification and scrutiny, further amendments were made to legislation backed by industry lobbying. Each incremental step lacked proper and rigorous analysis of the consequences of each amendment to, for example, the rights of other creditors and systemic risk, while the original narrow exemption gradually turned into a virtually unrestricted blanket exemption.[182] Schwartz uses the findings in the former to build up an argument that the exemptions may not protect against systemic risk but, to the contrary, may even amplify it.[183] The first exemption, a 'safe harbour' for derivatives was included into a bill which led to the enactment of the US Bankruptcy Code in 1978,[184] and which, according to Schwartz, concurrently was used to maintain an industry pressure on the US Congress to keep derivatives under safe harbour regimes. Set for historical path dependence, policy makers allegedly became blindsided when historical justification served as justifications

179 Darrell Duffie, David A Skeel Jr, 'A Dialogue on the Costs and Benefits of Automatic Stays for Derivatives and Repurchase Agreements' (2012) Faculty Scholarship 386, 1, 5–10 <https://scholarship.law.upenn.edu/faculty_scholarship/386> accessed 1 June 2019.

180 Ilya Beylin, 'A reassessment of the clearing mandate: how the clearing mandate affects swap trading behavior and the consequences for systemic risk' (2015–2016) 68 Rutgers U.L. Rev. 1143 1178–83.

181 For path dependence, subchapter 2.9.2.

182 Steven Schwartz, S Ori Sharon, 'The Bankruptcy-Law Safe Harbor for Derivatives: A Path-dependence Analysis' (2014) 71(3) Washington and Lee Law Review 1715.

183 Steven L Schwartz, 'Derivatives and collateral: balancing remedies and systemic risk' (2015) U. Ill. L. Rev. 699. Mokal (n 177) in turn builds his argument partially on the findings of Schwartz, Sharon (n 182): 'The process [of path dependence] began in 1978 when Congress accepted untested assertions by industry representatives about systemic domino risks in the commodities futures market' 74. Mokal continues how 'immunity apologists' do not pay any recognition to the costs of the immunities which have been 'illuminatingly analysed within a path-dependence theory' in Schwartz, Sharon (n 182) 73–74; Stephen Adams, 'Derivatives Safe Harbors in Bankruptcy and Dodd-Frank: A Structural Analysis' (March 3, 2014), also referring Schwarcz and Sharon (n 182) which, according to Adams, has 'persuasively argued that the development of the safe harbors represents "path-dependent" legislation', n 20. <https://ssrn.com/abstract=2348828> accessed 1 June 2019.

184 PL 95–598 (HR 8200), PL 95–598, § 764(c), Nov. 6, 1978, 92 Stat 2549; H.R. 8200 (95th): A bill to establish a uniform law on the subject of bankruptcies

for the extension of these safe harbours to bilateral close-out. Schwartz puts forward an important question of whether close-out netting actually reduces systemic risk.[185] The claim that the first amendment leading to the recognition of close-out netting was maybe unwarranted requires closer inspection. According to *Edward J Janger*, the motivation for the first safe-harbour, recognition of ipso facto clauses, netting, and enforcement of collateral, was to preserve the liquidity in the securities markets following a failure of a financial intermediary - even when it came at the expense of the failed intermediary.[186] In other words, the preservation of systemic stability (discussed further in Chapter 6) was an important public-policy objective already at the end of the 1970s.

Allegedly, a 'derivatives-industry representative' who had, using the domino analogy of one failure leading to failure of other market participants, 'argued that such an effect could occur because the commodities futures market is fragile'.[187] Schwartz and Sharon note that '[t]he initial exemptions-which were included in 1977 in the bill that became the Bankruptcy Code-were promoted by an attorney with ties to the derivatives industry, Stuart D Root'.[188] Several narrow exemptions were included in the bill which, according to Schwartz and Sharon, were backed with little evidence by the 'derivatives-industry representative-only one court case'[189] and how this claimed industry representative:

> [d]id not explain in his testimony before the Senate, however, why the inability of a commodities broker to freely close out an insolvent customer's account--or why a requirement that the broker seek court permission to close out that account-could cause the domino effect he warned against.[190]

The narrow exemptions were subsequently expanded in their scope.[191] Schwartz and Sharon do not provide evidence as to what kind of sponsorship was offered to who and by whom. However, the clear implication is that Root was not giving his statement in his capacity as a legal expert, from which the testimonies were heard, but as an industry lobbyist. Assumedly Root, as an advocate, was also bound by the

185 Schwartz (n 183) 702–04.

186 Janger (n 162) 2–4.

187 Schwartz (n 183) 703.

188 Schwartz, Sharon (n 182) 1724, noting that Root was a practicing lawyer who had advised institutional investors concerning aspects of the bankruptcy laws, n 43, later on stating that '[t]he origin of the path dependence was the lobbyist-sponsored limited exemption', 1737.

189 Geldermann & Co. v. Lane Processing, Inc., 527 F.2d 571 (8th Cir. 1975), to which Robert A Hudson refers to as 'leading case', Robert A Hudson, 'Customer Protection in the Commodity Futures Market' (1978) 58 B.U. L. Rev. 1, 28. In Geldermann, the court refers to earlier case-law.

190 Schwartz, Sharon (n 182) 1724–26.

191 Schwartz (n 183) 702–04.

rules and ethical standards of his Bar association. The evidence suggests that he was giving his statement in the capacity of a legal expert, from which the testimonies were heard - not as a lobbyist nor an industry representative. In the 1970s, there was considerable legal uncertainty as to the possibilities of a member of a clearing house to close-out a defaulting client, or in other words, there was 'little if any case law which defines the duties and responsibilities of commodities brokers towards their customers'.[192] The hearing was held at the end of 1970s, before there was hardly any bilateral OTC derivatives trading. During those times at the end of the 1970s it was turbulent globally and volatile in the US for which reason there was plenty reasons for market participants to hedge risks.[193]

The legal and systemic risk that a failure of an intermediary might pose is quite clearly acknowledged in the hearings by Root:

> If an FCM [a clearing member] is unable to limit its exposure to extreme price fluctuations through its inability to "closeout" a defaulting/ insolvent customer's account, then there is a potential domino effect. This has been judicially discussed in Geldermann and Company, Inc. v. Lane Processing, Inc., 527 F. 2d 571 (8th Cir. 1975) wherein the Court recognized the need for market stability or through a power to "close-out" an account in a contractual liquidation provision. It is clear that the liquidation provision promoted the interest and protection of the commission merchants, their customers and the investing public as a whole. [194]

The case referred to by Root, *Geldermann & Co. v. Lane Processing, Inc*[195] concerned futures commodity trading on the Chicago Board of Trade, an old operator of a futures and options exchange and also a central counterparty since the mid-19th century,[196] a volatile market situation, and a client who was 'out-of-the-money' in substantial amounts and had not posted enough collateral to its broker, who was a clearing member of the aforementioned exchange and central counterparty.[197]

192 George J Sotos, Kevin F Bowen, 'Commodities Regulation – The Proposed Suitability Standards for the Commodity Industry: Right Church, Wrong Pew' (1976) 53 Chi.–Kent L. Rev. 289, 290.

193 Stefan Gerlach, Srichander Ramaswamy, Michela Scatigna, '150 years of financial market volatility' BIS Quarterly Review, September 2006, 80–81 <https://ssrn.com/abstract=1632414> accessed 1 June 2019.

194 Bankruptcy Reform Act of 1978: hearings before the Subcommittee on Improvements in Judicial Machinery of the Committee on the Judiciary, United States Senate, Ninety-fifth Congress, first session, on S. 2266 and H.R. 8200, November 28, 29 and December 1, 1977, 1221–22 <http://archive.org/stream/bankruptcyreform1978unit/bankruptcyreform1978unit_djvu.txt> accessed 1 June 2019.

195 Geldermann (n 189) 27.

196 Randall S Kroszner, 'Lessons from Financial Crises: The Role of Clearinghouses' (2000) 18(2), Journal of Financial Services Research, 157, 162–63.

197 Hudson (n 189) 28.

Granted, the case did not involve a bankruptcy of a clearing member or automatic stay under the Bankruptcy Code, but the point is the systemic implications of having the right to contractually close-out a position, as stated in Geldermann:

> Investors or speculators who have failed to deposit sufficient maintenance margins may have insufficient financial resources to withstand substantial losses on the market and, if so, continued trading on that account is a financial risk for *the commission merchant, and ultimately for the commodities exchange if the loss suffered by the commission merchant exceeds its capital account*.[198]

While the court ruling does not refer to 'systemic risk', the chain of events described by the court, where the inability of one market participant, caused by operational or financial problems, leads to other market participants unable to fulfill their obligations when due, is at the very core of the definition of 'systemic risk'.[199] Instead of contextualizing their argument, Schwartz and Sharon focus on the choice of words of Root, given in a public hearing, who had described a 'potential domino effect' and extrapolate from this statement how the argument evolved into 'threat of market collapse' in 1982 through path dependence.[200] In Geldermann, the central legal question was that was the clearing member allowed to liquidate a customer account in accordance with the terms and conditions of their agreement and the exchange rules. It had, the court found, because of not having such right could pose a systemic risk. Later on, the Bankruptcy Code was amended accordingly. In bilateral close-out netting, the central question is whether an ipso facto clause can be enforced even if the Bankruptcy Code would normally limit the enforceability of all types of transactions. The central questions are essentially the same: can a contract or private rules, i.e. transnational law created by market participants in the course of trade, trump state legislation under certain circumstances, and if yes, what those circumstances are and what is the overriding public policy objective that justifies the exemption.

Central counterparties, an old type of private regulatory mechanism (discussed further in Chapter 6) that allows derivatives to be cleared differently than in over-the-counter derivatives trading, have strict policies on how they choose their

198 Geldermann (n 189) 27 (emphasis added).

199 The European Central Bank defines 'systemic risk': [t]he risk that the inability of one participant to discharge its obligations in a system will cause other participants to be unable to fulfil their obligations when they become due. This could potentially result in significant liquidity or credit problems spilling over into other systems or markets, thereby threatening the stability of the financial system. […]. European Central Bank, 'The Payment System: payments, securities and derivatives, and the role of the Eurosystem' (2010) 128 <https://www.ecb.europa.eu/pub/pdf/other/paymentsystem201009en.pdf> accessed 1 June 2019.

200 Schwartz, Sharon (n 182) 1724–1726; Schwartz (n 183) 703.

members. The members of these private regulatory mechanisms have to be large financial institutions with sufficient capital, risk management systems, and expertise among others, because should anyone of them default, the default rules of a central counterparty require that the other members and eventually the CCP itself are liable for the liabilities of the defaulted clearing member.[201] Should a customer of a clearing member default, something extraordinary would have had to take place in the financial markets.[202] For this reason, the maintenance of financial stability can be argued to weight more than the interests of a single defaulted counterparty. The systemic risk a failure of one counterparty is clearly reflected in Geldermann where it is stated that 'imposing requirements of demand and notification [...] would violate the manifest purpose of the [contractual] liquidation provision'. The court ruled that the liquidation rules of the exchange permitting the liquidation of a customer account were enforceable.[203] Furthermore, it is of general interest that the court notes how the commercial environment, 'mores and business practices', the risks and 'needs of business' are factors in assessing whether a private norm, in this case contractual liquidation provision created in the course of trade, could have more legal weight than enacted legislation on the basis that the former promotes a public policy objective of financial stability.[204]

The Bankruptcy Code was subsequently amended in 1982, widening the exemptions for automatic stay, and in 1984, exempting repurchase agreements from the same.[205] In 1990, the safe harbours introduced in the earlier amendments were extended to bilateral OTC derivatives transactions.[206] Was it warranted for the OTC derivatives industry to claim that in bilaterally cleared OTC derivatives transactions the risks could be similar (mandatory stay and cherry picking) and, based on this, claim that allowing close-out netting should be extended to these transactions as well? With the benefit of hindsight and considering contemporary research, maybe it is questionable that the OTC derivatives industry engaged in a deliberate strategy to use established arguments as a justification for future safe harbours and even less warranted for regulators to accept such arguments.[207]

201 Jon Gregory, *Central Counterparties – Mandatory Clearing and Bilateral Margin Requirements for OTC Derivatives* (Wiley Finance 2014) 27–41, 181–84.

202 In the US financial crisis of 1907, CCPs successfully innovated their way through the crisis and played an important part in maintaining market confidence and mitigating panic bank runs through private solutions. Kroszner (n 196) 159–62.

203 Geldermann (n 189) 27.

204 Geldermann (n 189) 23.

205 Schwartz, Sharon (n 182) 1727–29; Amicus Curiae (n 99); The Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. clarified the legal status of bilaterally negotiated swap agreements that would not be characterized as securities, Amicus Curiae (n 99) 21–23.

206 Schwartz, Sharon (n 182) 1729–31.

207 Schwartz, Sharon (n 182) 1730.

The systemic implications or the actual systemic risk that a bankruptcy of a major dealer bank due to lack of recognition of bilateral close-out netting in the Bankruptcy Code posed at that time can only be speculated on. What is known now, and what was known then, is that the financial institutions were large already in 1984,[208] the OTC derivatives market was evolving and growing very rapidly during those times,[209] and the legal risks arising from mandatory stay and cherry picking were real,[210] which were recognized and assumedly analyzed by regulators, national and transgovernmental alike, as well as central banks.[211] Many arguments can be made against the desirability of enforceability of bilateral close-out netting. The evidence suggests that the origins of close-out netting cannot be adequately explained through path dependence nor can it be said that the foundations of close-out netting would have been laid on a legally 'shaky' ground.

5.8 MARGINING AND FINANCIAL COLLATERAL

5.8.1 REGULATORY RECOGNITION OF TRANSNATIONAL MARKET PRACTICE

Collateralization and margining are used here interchangeably as techniques to reduce credit risk under any kind of derivatives transaction, both multilaterally and bilaterally cleared, in and out of exchanges. Put into a modern context, financial collateral flows 'lie at the heart of any proper understanding of market liquidity, and hence of financial stability'. [212] It is financial collateral that ties nonbanks and banks together and form the 'nuts and bolts of financial plumbing' that find their written form in the standardized agreements of private trade organizations, including ISDA MA.[213]

Margining is a method to control credit risk. In multilateral clearing, it has been used at least since the mid-19th century.[214] Simply put, margining means covering of an out-of-money position with cash or securities. If Party A is out of the money 5 units on day 1 to Party B, Party A will transfer cash or securities to Party B as collateral. If Party A fails, Party B's exposure is zero, as it already has collateral that covers its exposure. Since markets and prices move, Party B might be out-of-the-money on day 2 and thus obliged to transfer collateral to in-the-money Party A. Margining in

208 James Barth, Moutusi Sau, 'The Big Keep Getting Bigger: Too-Big-to-Fail Banks 30 Years Later' (September 24, 2014) 1, 2 <https://ssrn.com/abstract=2510041> accessed 1 June 2019.

209 (n 19.)

210 Waldman (n 97), Nalbantian and others (n 84), Henderson (n 12); Cunningham (n 7).

211 Subchapter 5.6.1.

212 Manmohan Singh, 'Collateral Reuse and Balance Sheet Space' IMF Working Paper 2017 WP/17/113, 5.

213 ibid n 1, n 4, n 10.

214 Kroszner (n 196) 157; JW Markham, 'Federal Regulaton of Margin the Commodity Futures Industry – History and Theory' (1991) 64 Temple Law Review 59

the OTC derivatives market was originally a non-mandatory market practice. This market practice achieved legal recognition and margin became known as *financial collateral* in the EU through the introduction and national transposition of the Financial Collateral Directive (FCD).[215] The purpose of the FCD is to abolish local formalities relating to the creation of financial collateral arrangements, recognize title transfer and reuse of collateral, disapply national insolvency laws relating to the enforceability of close-out netting, and the effective enforcement of financial collateral.[216] The legal recognition of margining and financial collateral arrangements precedes FCD. For example, France enacted a law in 1996 that facilitated the use of securities account pledges and ensured their legal recognition in French insolvency law. The new law was to offer 'a flexible and new framework for more creative financial engineering in structured financings'.[217] The FCD was introduced in an era when public financial regulation became more voluminous and more pervasive, whereas self-regulation backed by national legislation receded.[218]

Article 7 of the FCD requires Member States to recognize the enforceability of collateral arrangements 'to ensure that a close-out netting provision can take effect in accordance with its terms'. Article 2 of the FCD defines 'financial collateral arrangement' as 'a title transfer financial collateral arrangement or a security financial collateral arrangement whether or not these are covered by a master

215 2002/47 Directive of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements [2002] OJ L168/43 (FCD).

216 FCD Article 7:

1. Member States shall ensure that a close-out netting provision can take effect in accordance with its terms:

(a) notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures in respect of the collateral provider and/or the collateral taker; and/or

(b) notwithstanding any purported assignment, judicial or other attachment or other disposition of or in respect of such rights.

Article 8

Member States shall ensure that a financial collateral arrangement [...] may not be declared invalid or void or be reversed on the sole basis that the financial collateral arrangement has come into existence, or the financial collateral has been provided:

(a) on the day of the commencement of winding-up proceedings or reorganisation measures, but prior to the order or decree making that commencement; or

(b) in a prescribed period prior to, and defined by reference to, the commencement of such proceedings or measures or by reference to the making of any order or decree or the taking of any other action or occurrence of any other event in the course of such proceedings or measures;

For English law perspective, Dermot Turing, Karen Lester, 'Implementation of the EU Directive on Financial Collateral Arrangements in the United Kingdom' (2005) 20 J.I.B.L.R. 65; for a more general EU member state perspective, Klaus Lober, Ewa Klima, 'The implementation of Directive 2002/47 on financial collateral arrangements' (2006) 21 J.I.B.L.R. 203.

217 Stephane Mouy, Edward Nalbantian, 'France Modernizes Collateralization and Netting' (1996) 15 Int'l Fin. L. Rev. 26, 28.

218 Eddy Wymeersch, 'The Implementation of the ISD and CAD in national legal systems' in Guido Ferrarini (ed), *European Securities Markets – The Investment Services Directive and Beyond* (Kluwer Law International 1998) 8–16.

agreement or general terms and conditions'. In essence, collateralization benefits the in-the-money counterparty. If the out-of-the-money party defaults, the in-the-money party benefits from having at least part of its position already covered with financial collateral either as the title holder or security holder. Financial collateral is used in two forms which are referred to as 'variation margin' (VM) and 'initial margin' (IM). While both share the same purpose of mitigating counterparty credit risk, they operate differently and often under different legal structures. Put simply, VM represents the running profit/loss of a derivative.[219] This means that every moment, the value of the transaction changes. The 'in-the-money' party has a claim on the 'out-of-the-money' counterparty and conversely the latter must post VM to the former to cover this position.

Historically, this daily valuation and transfer was not mandatory. Under current financial regulation, namely EMIR in the EU, VM must be exchanged daily or even intra-daily. If one party to a transaction defaults, the non-defaulting party will incur costs as it will have to re-establish its positions by entering into new transactions with a new counterparty. IM is meant to cover these as well as other related expenses. Post-GFC under EMIR, the exchange of VM, and gradually also IM, has become mandatory also in bilaterally-cleared OTC derivatives transactions. These rules have transgovernmental origins. The framework was laid out by the Basel Committee of Banking Supervision and and the International Organization of Securities Commissions (IOSCO). The new rules have given rise to many legal risks in the OTC derivatives market. [220]

5.8.2 ISDA FACILITATED MARGINING IN THE OTC DERIVATIVES INDUSTRY

According to the Commodity Futures Trading Commission, a US regulatory agency, in 2014:

> Well-designed margin systems protect both parties to a trade as well as the overall financial system. They serve both as a check on risk-taking

219 Basel Committee on Banking Supervision, Board of the International Organization of Securities Commissions, 'Margin requirements for non-centrally cleared derivatives' September 2013, 2(e), 8 <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD423.pdf> accessed 1 June 2019.

220 For the legal risks in uncleared derivatives, Barney Reynolds, Donna Parisi, 'The effects of trans-Atlantic reform on margin for uncleared swaps: balancing the risks and benefits of uncleared swaps' (2016) 31 J.I.B.L.R. 59; Joseph Tanega J, Andrea Savi, 'Central Clearing Counterparties for OTC-users: A Theoretical Framework' (2017) 13 N.Y.U.J.L. 825, 847–55; for the legal risks in cleared derivatives, Jo Braithwaite, 'The dilemma of client clearing in the OTC derivatives markets' (2016) EBOR <http://eprints.lse.ac.uk/64476/> accessed 1 June 2019; Simon Goldsworthy 'Financial Collateral Arrangements in the Age of Uncleared Margin' (2016) 7 Journal of International Banking & Financial Law 390.

that might exceed a party's financial capacity and as a resource that can limit losses when there is a failure by a party to meet its obligations.[221]

In the 1990s, margining was becoming increasingly commonplace in finance. In the OTC derivatives market the use of financial collateral became, while not mandatory, so commonplace in the early 1990s that ISDA found an incentive to standardize also the terms and conditions of margining into the ISDA MA architecture.[222] Margining was born out of market demand, and its use developed into market practice. This development, in turn, called for contractual standardization. Originally, it was up to the counterparties to decide whether to use margin or not. By the end of the 1990s, given that margining was becoming so commonplace in the financial markets, it further evolved into a question of public policy and regulatory recognition. [223] The market, once transnational, became renationalised and fragmented along national jurisdictions which gave rise to legal uncertainties. [224]

At least from the early 1990s, while contractual netting in its various forms was starting to be recognized and promoted by regulators, market participants, both dealers and end-users, sought new ways to further mitigate credit risk through margining. In general, margining was becoming more commonplace in finance, OTC derivatives trading included. [225] It was important for market participants to be able to reuse the received collateral under an OTC derivative transaction as this alternative opened up new financing opportunities in the repurchase market where the same collateral could be used to raise cash in this market.[226] However, these new collateral arrangements varied significantly from how collateral was traditionally understood in the form of pledges, mortgages, and charges that were used to create enforceable security interests. Unlike in debt financing, for example, at the commencement of an OTC derivatives transaction, creditor and debtor is unknown as it depends on the

221 Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, proposed rule, (2014) Vol. 79 Fed. Reg. at 59901.

222 Raul Oscar Elias, 'Legal aspects of swaps and collateral' (2001) 3 J.I.F.M. 232, 233.

223 The European Commission, Financial Services: Implementing the framework for financial markets: Action Plan, COM (1999)232, 11 May 1999, noting that '[t]here is a higher risk of invalidation of cross-border collateral arrangements and uncertainty as regards enforceability should the collateral provider become insolvent' 8 <http://ec.europa.eu/internal_market/finances/docs/actionplan/index/action_en.pdf> accessed 1 June 2019.

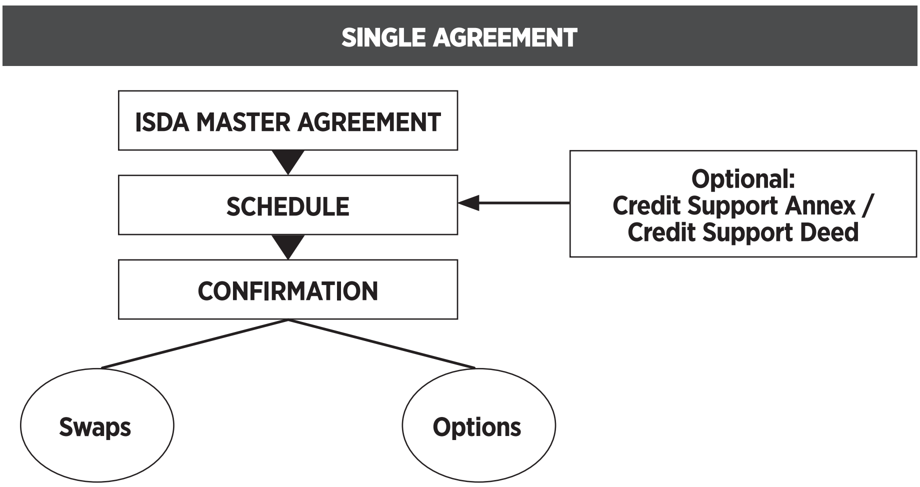
224 Subchapter 3.6. For an earlier analysis of the transposition of the FCD in the UK and its implications on the ISDA MA provisions especially in relation to close-out netting, Anthony Fawcett, 'The Financial Collateral Directive: an examination of some practical problems following its implementation in the UK' (2005) 20 J.I.B.L.R. 295, 296; Look Chan Ho, 'The Financial Collateral Directive's practice in England' (2011) 26 J.I.B.L.R. 151.

225 Daniel Cunningham, Thomas Werlen, 'Derivatives and the Reduction of Credit Risk' (1996) 15 Int'l Fin. L. Rev. 35, 36, noting that the use of collateral was one technique out of many, 35, 36; Christian A Johnson 'At the Intersection of Bank Finance and Derivatives: Who Has the Right of Way?' (1998–1999) 1, 47–49, n 2, n 254, n 256–263.

226 Christian A Johnson, 'Derivatives and Rehypothecation Failure: It's 3:00 P.M., Do You Know Where Your Collateral Is' (1997) 39 Ariz. L. Rev. 949, 966, 969–71.

market movements from which the transaction derives its value from. Depending on these movements, either one of the counterparties can be in-the-money or out-of-the money on each day before the maturity of the transaction. The particular nature of OTC derivatives gave rise to new types of legal risks.[227] Market participants developed and used their own security agreements to facilitate collateral arrangements under their OTC derivatives transactions but as they were unstandardized, the negotiations required were slow.[228] ISDA introduced separate collateral documentation known as Credit Support Annex (CSA) and Credit Support Deed (CSD) that formed a part of the existing master agreement architecture.

TABLE 2 Simplified Architecture of the ISDA Master Agreement 1992



CSA and CSD included provisions for how to determine the amount of collateral and how often it needs to be transferred, as well as whether the obligation concerns both parties or only one of the parties.[229] From the beginning of collateralization, collateral could be in the form of currencies, government bonds, or some other type as agreed between counterparties.[230]

The first CSA introduced by ISDA was the 1994 ISDA Credit Support Annex (New York law) that could be added to the existing ISDA MA architecture by way of reference to its Schedule. Essentially, the same contractual technique that had been used to expand the applicability of the ISDA MA architecture was now being

227 Subchapter 4.7.3.

228 Johnson (n 226) 965.

229 Cunningham, Werlen (n 225) 36.

230 Zepeda (n 57) 313.

used for collateralization. CSA formed a part of the single agreement structure.[231] The first ISDA Credit Support Annex was followed by the 1995 ISDA Credit Support Annex (Title Transfer) and the 1995 ISDA Credit Support Deed (Security Interest) both governed by English law. The English law version came out in two optional versions due to the English property laws that limited and restricted the rights of the collateral holder to reuse the financial collateral in specific situations. [232] Both English and US law CSAs are approximately 10 pages long, with approximately 7 pages of standard terms and conditions and, similar to Schedule, 3 pages of optional provision that the parties can customize based on standardized language or other provisions that the counterparties can include to the collateral at their choosing.[233]

In addition to facilitating the control of credit risk, CSA and CSD were to control the legal risks arising from English and other national laws especially in relation to the creation, perfection, and enforcement of collateral arrangements. These requirements arising from national property laws fitted poorly with the new fast-paced trading environment where the only thing resembling anything tangible and physical was to be found from book-entries on computers and where collateral was to be reused quickly elsewhere.[234] Within a few years, the recognition and ensuring the legal enforceability of security-interest based collateral arrangements was becoming increasingly a public policy objective in the EU.[235]

Through title transfer arrangement made under the CSA, a collateral taker could reuse the collateral. This right was subject to the obligation to return and replace the original collateral with a fungible collateral to which the same terms apply

231 In the US, although standalone CSAs were used as separate contracts, it followed from the wording of the US Bankruptcy Code that (referring to a transfer of a collateral under a 'swap agreement') it would be safer to make the collateral arrangement a part of the master agreement architecture. Cunningham, Werlen (n 225) 6.

232 Cunningham, Werlen (n 225) 35–36.

233 Harding (n 12), Annex 1, ISDA Credit Support Annex (English law) and Annex 2 ISDA Credit Support Annex (New York law). Paragraph 13 (Elections and Variables) include provisions relating to, among others, issues such as what type of collateral can be used (cash, negotiable debt obligations), thresholds for transfer (the exposure must exceed certain threshold amount for the obligation to transfer collateral to become applicable), minimum transfer amounts (the exposure must exceed certain smaller threshold for the obligation to transfer collateral to become applicable), and dispute resolution. The dispute resolution provision requires the counterparties to settle their valuation disputes in a certain manner, and only if the dispute persists, the counterparties can seek court settlement.

234 Raul Oscar Elias, 'Legal aspects of swaps and collateral' (2001) 3 J.I.F.M. 232, 237–42.

235 FCD, Recital (5)

In order to improve the legal certainty of financial collateral arrangements, Member States should ensure that certain provisions of insolvency law do not apply to such arrangements, in particular, those that would inhibit the effective realisation of financial collateral *or cast doubt on the validity of current techniques such as bilateral close-out netting* […]' (emphasis added); FCD

Recital (9)

[t]he only perfection requirement which national law may impose in respect of financial collateral should be that the financial collateral is delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker or of a person acting on the collateral taker's behalf […].

as to the original. The CSA did not create a security interest in the underlying collateral, but instead was built on the idea that the legal title to the collateral was to be transferred. If the collateral taker reuses the collateral, the legal character of the collateral might change to a form not intended by the parties.

The CSD combines elements of the English law fixed charge and common and civil law pledge to recognise the English law fixed charge as well as continental European security interest types. In short, like the CSA, the CSD operates as to first valuate all ongoing OTC derivatives transactions between the counterparties which determines a net replacement cost as if all transactions were terminated. In order to reduce the risk of the arrangement being recharacterized by courts as something else than a collateral arrangement, the transferee may not rehypothecate or reuse the financial collateral unless the counterparty defaults. Under the fixed charge, the collateral taker has only a partial interest in the collateral and not an outright ownership which remains with the collateral giver. If the collateral giver defaults, the collateral taker can claim any possible amount of collateral on the basis of its rights as a secured creditor.[236]

For the present purposes, it is enough to understand that the out-of-the money counterparty transfers financial collateral to the in-the-money counterparty. Thus, the collateral represents the running profit/loss of a derivative.[237] Upon counterparty default, the obligation to return the equivalent amount of collateral would then be converted to a monetary value that in turn would be used in the close-out calculation. The possibility for the collateral holder to reuse the collateral was 'possibly the most significant' aspect for using title transfer CSA.[238] While the title transfer CSA allowed for more flexible financing for the collateral taker, English law gave legal effect to this arrangement, in cross-border contexts the use of financial collateral came with a legal risk. One legal risk was that of recharacterization of the title-transfer arrangement as a security interest or a pledge in other jurisdictions. This could mean that the title transfer CSA arrangement could be rendered unenforceable on the grounds of not complying with foreign property laws[239] or invalidate the position of the creditor from a secured creditor (with a title to collateral) to an unsecured creditor in a foreign bankruptcy proceeding concerning its forcing counterparty.[240]

236 Hval (n 87) 812–13; Paul C Harding, Christian Johnson, *Mastering the ISDA Collateral Documents*, (2nd edition, Pearson Education 2012) 38–39.

237 Basel Committee on Banking Supervision, Board of the International Organization of Securities Commissions, 'Margin requirements for non-centrally cleared derivatives' September 2013 <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD423.pdf> accessed 1 June 2019.

238 Peter S Smedresman, Michael A Kenney, 'Solving the Puzzle of Cross-border Securities Pledges' (1996) 15 Int'l Fin. L. Rev. 15, 19.

239 ibid 19. Choice of law rules are at the centre of these considerations. For an earlier practical example regarding the *lex situs* rule and perfection of immobilized or dematerialized securities, Hval (n 87) 10, 19–22.

240 One example of this is the risk of *overcollateralization*, where the pledgor has transferred more collateral to the pledgee than was required and the pledgee is declared bankrupt while holding this excess collateral.

5.8.3 LEGAL RISKS IN FINANCIAL COLLATERAL ARRANGEMENTS

The legal risks of margining have been at the centre of regulatory attention dating back at least to the 1990s and have been exceedingly so since the GFC. However, the key legal definitions and concepts still vary across jurisdictions, regulators, and market participants.[241] Much of the legal uncertainty concern how 'reuse' and 're-hypothecation' in margining are understood. The Financial Stability Board has identified the challenges for regulatory harmonization. First, there is regulatory variation as to how re-hypothecation is defined. Re-hyphotecation is 'deeply correlated with securities and insolvency laws, as well as structures of markets [...] which are very different among jurisdictions'.[242] Second, the differences in interpretation depend on the different public policy objectives of individual jurisdictions. Third, its meaning also depends on the functions of different financial intermediaries, and fourth, also on the other laws and regulatory regimes not related strictly to margining that may directly or indirectly affect the implementation of rehypothecation rules.[243] Similarly, the French financial regulator Autorité des Marchés Financiers notes that '[t]here is no systematic distinction between 'reuse' and 'rehypothecation' in the currently available economic literature or data, when it is a question of collateral reuse, with or without transfer of ownership between parties'.[244] For the purposes of this research, the right of reuse of collateral refers to the right of a secured party or a custodian to sell, pledge, rehypothecate, assign, invest, use, commingle, or otherwise dispose of posted collateral.

The use of financial collateral has always come with legal risks. Perhaps the most important source of legal uncertainty was that the application of *lex situs*

The amount of collateral exceeding the amount that was actually required could be recharacterized as an unsecured debt meaning a delay in the recovery or losing of the excess amount in whole if the party holding the excess collateral would become bankrupt. This risk was acknowledged early on. Johnson (n 226) 992–93; the same risk persists today, Thomas Keijser, G Morton, Marcel Peeters, 'Financial Collateral: From Private to Regulatory Law Reform' in Thomas Keijser (ed), *Transnational Securities Law* (OUP 2014) paras 22.5–23.5; overcollateralization serves a commercial purpose, Markus Krebzs, *Securitization and Structured Finance Post Credit Crunch: A Best Practice Deal Lifecycle Guide* (Wiley 2011) 73–74.

241 BIS, Committee on the Global Financial System Bank for International Settlements, May 2013:

[t]here is no clear standard, and different definitions of collateral assets exist among regulators, central banks and market participants. Moreover, the definition of a collateral asset differs depending on the purpose and the risk profile of the institution accepting the underlying asset, either as collateral or for investment purposes, 15;

[t]he terms rehypothecation and reuse of securities are often used interchangeably; they do not have distinct legal interpretations, 17 <https://www.bis.org/publ/cgfs49.pdf> accessed 1 June 2019.

242 FSB, 'Transforming Shadow Banking into Resilient Market-based Finance, Re-hypothecation and collateral re-use: Potential financial stability issues, market evolution and regulatory approaches, 25 January 2017, 29 <https://www.fsb.org/wp-content/uploads/Re-hypothecation-and-collateral-re-use.pdf> accessed 1 June 2019.

243 ibid 28–29.

244 Autorité des Marchés Financiers, 'The Reuse of Assets – Regulatory and Economic Issues' November 9, 2016, 12.

rule under which the applicable law is from where the security is located.[245] Technological advancement that allowed market participants to switch physical securities documentation first into immobilized form, and then to dematerialized form in electronic systems, did not make this task easier. Under the ISDA MA, a collateral could be split among three jurisdictions following the application of the lex situs rule: the law governing the (English law) CSA, the law of the jurisdiction where a court deems the collateral to be in, and the (bankruptcy) laws applicable to a defaulting counterparty.[246]

In the early 2000s, the Commission went on to conclude that there was a demand for:

> [a]n effective and simple Community regime for the creation of collateral; providing limited protection of collateral arrangements from some rules of insolvency law, particularly those that would *inhibit the effective liquidation of collateral or cast doubt on the validity of techniques currently used* creating legal certainty with regard to cross-border provision of collateral [...][247]

Such legal risks stemmed typically from formal perfection requirements even for the type of collateral that is reused constantly, and the legal risk that in a case of insolvency of the counterparty, the collateral arrangement being treated as preferential treatment.[248] As the Financial Collateral Directive (FCD) was not a full harmonization directive,[249] the market participants knew that national transposition would also bring legal uncertainty.[250] Other legislation initiatives were made. The 'place of the relevant intermediary' rule (PRIMA) embodied in Article 9 of the Settlement Finality Directive[251], took the *lex situs* principle to a new level by recognizing that the location of the intangible asset is where the situs is determined by the law governing the account agreement between investor and intermediary. However, a private initiative conducted under the auspices of a public international

245 Subchapter 3.6.

246 Hval (n 87) 14–15.

247 Communication from the Commission to the European Parliament pursuant to the second subparagraph of Article 251 (2) of the EC Treaty concerning the Common Position of the Council on the adoption of a Directive of the European Parliament and of the Council on financial collateral arrangements, SEC/2002/0278 final, no longer in force (emphasis added).

248 James Coiley, 'New protections for cross-border collateral arrangements: summary and analysis of draft EU Directive on financial collateral' (2001) 16 J.I.B.L. 119, 119–120.

249 2002/47 Directive of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements [2002] OJ L168/43.

250 Coiley (n 248) 123.

251 98/26/EC Directive of 19 May 1998 on settlement finality in payment and securities settlement systems [1998] OJ L166/45 (Finality Directive).

organization adopted a different approach. Under this approach, the governing law is determined by the law governing the relevant contract.[252] PRIMA rule gives rise to legal risk and can be seen as outmoded in that it does not reflect actual commercial practices[253] nor, put in another way, the lex mercatoria of book-entry systems.[254] This uncertainty relates among others to what constitutes 'possession' or 'control' of financial collateral under Article 2 (2) of the FCD and how they are interpreted in light of national transposition acts, as well as in the national legal orders.[255] Taxation of reused collateral can also be a source of legal risk as demonstrated in the following subchapter.

5.8.4 CASE STUDY: FINANCIAL COLLATERAL AND DOMESTIC APPLICATION OF TRANSNATIONAL LAW

The combination of transnational legal theory and court case analysis may produce results that can inform lawyers on how transnational markets operate, what is legal pluralism between private legal order and state legal order, and how and by which processes transnational law emerges and is enforced. In other words, understanding transnational contracts, their creators, and heterogenous users can bring aid in understanding one account and interpretation of 'what is transnational law'.[256] One interesting question is what happens when a civil law court applies the laws of its legal system to a case involving transnational contracts? Is the state legal system able to give legal weight to transnational norms? Or can it even acknowledge their existence? In a hypothetical scenario involving transnational elements, it would seem obvious from the outset that referring to terms unknown to the judiciary may not bring satisfactory results. In other words, appealing directly to transnational law or the transnational nature of contracts as a legal argument may be made in vain if the national legal order does not acknowledge even the concept.

The preliminary ruling KHO 2012:112[257] of the Finnish Supreme Administrative Court (SAC) suggests that transnational contracts do have legal weight but not

252 Chapter 3 (n 265).

253 Roy Goode, Hideki Kanda, Karl Kreuzer, *Hague Securities Convention – Explanatory Report* 19–20 (2nd edition, 2017) <https://assets.hcch.net/docs/d1513ec4-0c72-483b-8706-85d2719c11c5.pdf> accessed 1 June 2019.

254 Jan Dalhuisen, *Dalhuisen on Transnational Comparative, Commercial, Financial and Trade Law. Volume 2, Contract and Movable Property Law* (6th edition, Hart Publishing 2016) 627–28, noting also how the PRIMA rule facilitated regulatory arbitrage regarding the choosing of the applicable law.

255 Elena Christine Zaccaria, 'An inquiry into the meaning of possession and control over financial assets and the effects on third parties' (2017) J.C.L.S. 1, 7–10; generally, Goode and others (n 253).

256 Joan Braithwaite, 'Standard Form Contracts as Transnational Law: Evidence from the Derivatives Market' (2012) 75 The Modern Law Review 779, 798, 804.

257 KHO 2012:112, docket 265/2/12, 12 December 2012.

necessarily as stand-alone arguments. The case involved a transnational contract, ISDA MA, and one of the core areas of state sovereignty, taxation. This makes this case illustrative for the purposes of this research, thus it is described and analyzed in some detail.[258] Underpinning the case is the Supreme Administrative Court of Finland, the highest appeal court in administrative cases where the lawfulness of lower administrative decisions may be challenged. The legal issue concerned the taxation of a collateral transfer under Finnish law executed under the ISDA Master Agreement architecture.

The Finnish Act Laki elinkeinotulon verottamisesta ('Act on Income from Professional Activities', AIPA)[259] Chapter 1 Section 4 stipulates that every type of income, cash or benefit of monetary value, earned from business activities is subject to a business income tax. AIPA Chapter 1 Section 5 further includes a non-exhaustive list of types of business income that is subject to business income tax. As a general rule, all title transfers are by default subject to business income tax. AIPA does not recognize the concept of financial collateral but nevertheless title-transfer arrangements are recognized in Finnish law following the transposition of the Financial Collateral Directive through the Financial Collateral Act (FCA).[260] Article 6 of the Financial Collateral Directive stipulates that 'Member States shall ensure that a title transfer financial collateral arrangement can take effect *in accordance with its terms*'. (emphasis added). FCA Section 5 explicitly recognizes the right to agree on an arrangement in which the collateral provider transfers securities or cash by way of title transfer.

The Finnish tax authorities deemed the transfer of collateral between A and B to constitute the passing of ownership from one party to the other. Under national tax law, this interpretation effectively meant that collateral transfers were subject to business income tax under AIPA Chapter 1 Section 5, if the transferee reused a financial collateral. The Central Tax Board of Finland, a public body that issues preliminary rulings regarding taxation, consequently confirmed this view in its ruling. [261] The ruling is detailed in its background coverage of the legal nature and even the background of the ISDA MA architecture and the use of financial

258 Anne Oravainen, 'KHO 2012:112 – Vakuusluovutuksen verokohtelusta' (2013) 7–8 Lakimies 1376.

259 Laki elinkeinotulon verottamisesta, 1968/360, as amended.

260 Rahoitusvakuuslaki 11/2004, as amended, which is the national transposition act of FCD. It is noteworthy that FCD Article 6 sets an obligation for the Member States that are required to 'ensure that a title transfer financial collateral arrangement can take effect in accordance with its terms' - the terms in this case being the terms of the ISDA Master Agreement executed between Party A and B. If there are tax consequences for title transfer collateral arrangement, it is questionable if the arrangement can take effect with its terms the purpose of which is not to create a tax obligation for the counterparty.

261 Keskusverolautakunta, Helsinki 23.11.2011, ennakkoratkaisu n:o 69/2011, 6 [Preliminary ruling of a tax appellate body - authors note].

collateral in the OTC derivatives markets. Nevertheless, reuse equalled to taxable transaction.[262]

The decision was appealed in the Supreme Administrative Court. In its ruling, contrary to the decision of the tax authorities and the preliminary ruling of the Central Tax Board, the Supreme Administrative Court concluded that the arrangement differed from an ordinary type of taxable title transfer. Put simply, the title transfer does not extend to interests or yields of financial collateral - these belong to the collateral giver regardless of the title transfer - the purpose of which is provide for a guarantee of fulfillment contractual obligations. Furthermore, the Supreme Administrative Court emphasized that the arrangement followed the prevailing market practices, referred directly to the ISDA contractual architecture commonly used in the OTC markets, and the ratio of FCA in facilitating the use of financial collateral for the purpose of limiting credit exposure to the counterparty. The Supreme Administrative Court also emphasized that in the IFRS accounting, the collateral remains in the collateral transferor's balance sheet despite the transfer of title.[263]

As also noted by *Anne Oravainen*, the Supreme Administrative Court market practice outweighed tax considerations in a situation where tax, financial collateral, and market practice view the same set of facts from different perspectives. Legal certainty was also at stake for both market participants and the tax authorities, both having their own views on what decision would have been predictable and justified from the perspective of legal certainty.[264]

Due to business secrecy, publicly available sources do not tell how the market participants subject to AIPA dealt with the situation. Some guidance can be found by reading the transnational contract itself. A Finnish counterparty, subject to AIPA, who was to be the in-the-money party and would receive financial collateral from its counterparty and then use this collateral elsewhere, would be subject to tax while not being able to reclaim the amount paid in taxes from its counterparty under the standard terms of the ISDA MA. However, such an 'Affected Party', in the parlance of the ISDA MA, would likely have the right to terminate the transactions affected by the tax ruling.[265] Effectively, this would disadvantage some parties subject to this tax treatment in comparison to those who are not.

In essence, the legal question was about recharacterization of the title transfer arrangement on financial collateral. Regarding the facts of the case, two parties, A and B, had entered into an ISDA MA arrangement with the purpose of using a Credit Support Annex to facilitate the transfer of financial collateral between the

262 ibid.

263 KHO 2012:112.

264 Oravainen (n 258) 1376.

265 Harding (n 12) 76-7, 232-3, 249-50; Chapter 4 (n 218).

parties during the term of the contract. Put simply, should A owe to B 10 units of currency under their current position in derivatives transaction(s), A would have to post financial collateral (variation margin) to B for the same amount, and vice versa, to cover their respective positions.[266] First, the collateral taker has the title of ownership to the transferred collateral, meaning that the collateral taker may reuse the received financial collateral as it sees fit instead of just holding the collateral. The right of reuse follows from the transfer of title, and in the transnational market, financial collateral is in circulation and reused constantly.[267] Second, the collateral giver has the right to use various types of financial instruments to satisfy the collateral requirement, and, in other words, it is essentially not required to post a specific type of financial instrument. Third, financial instruments by their nature accrue yield, interest for bonds, and dividends for shares, prior to their maturity. The market standard is that when the collateral is held by either A or B, the title to this yield is *not* transferred to the collateral taker but the collateral taker is required to compensate the accrued yield to the collateral giver: the title of ownership concerns the financial instruments used as collateral, not the yield. The purpose of the collateral is to cover the position of the 'in-the-money' party, not to transfer the economic rights to the collateral which remains with the 'out-of-the-money' party.

From a legal theoretical perspective, the case involved interactions between transnational law, supranational and national law. First, it involved transnational law in the form of IFRS accounting standards and the ISDA Master Agreement, as well as financial collateral itself, a private construct. Second, it involved a supranational element in the form of Financial Collateral Directive designed together with public and private regulators to bring, among other things, legal certainty to the financial markets.[268] Third, it involved a national transposition law, the FCA, which needed to be weighed against another national law, the AIPA, which reflects the core element of national sovereignty, taxation. It may be inconsequential whether the Supreme Administrative Court would have been able to characterize the case as a matter of transnational law in verbatim. Referring directly to the transnational contract as a manifestation of market practice allowed for transnational law to have some legal weight over the interpretation of local tax authorities on the legal nature of financial collateral. However, this argument alone would probably not have sufficed to outweight the interpretation of the tax authorities, who based their argument on national tax law, but had to be accompanied with 'hard law', i.e. the national transposition act of the FCD which, in turn, has its origins in transnational law borne out of merchant practice.

266 Subchapter 5.8.1.

267 ibid.

268 ibid.

5.9 FINTECH THEN AND NOW: EVOLUTION DOES NOT STOP

Much of the description given in this chapter can be viewed merely as a historical account. The point of the chapter is to emphasize that many drivers affect how finance and law interact, and that we do not have foresight on evolution. In the 1980s, ISDA was a driver for contractual simplification, not only intentionally, but also without premeditation. Those derivatives that became in demand were contractually standardized through industry co-operation and those products that remained more exotic, i.e. they were so bespoke in their economic substance that the product could 'fit' only to one or relatively few buyers.[269] It was an industry driven largely by market demand for financial innovation that turned into identifiable products and product categories that had a somewhat identifiable life cycle and characteristics.[270]

Importantly, from an evolutionary perspective, the more frequently a type of new derivative product was traded, the more incentive the market participants had to co-operate to agree on relevant definitions for this new product. First, this would mean that such definitions would have to be included in the confirmation of such trades. In other words, rather than including only the economic terms of a trade, the counterparties had to make longer confirmations (known as 'long form confirmation' referring to situations where the counterparties had not signed an ISDA MA[271]). This was the only way to include the new product descriptions and related terms and conditions to the ISDA MA architecture that did not yet recognise specific definition booklets that would allow the ISDA MA to be expanded to also cover new types of products. However, once the supply and demand for a new type of financial derivative continued to grow, it was for ISDA to step in and standardize commonly accepted definitions for each new class of derivatives products. This would allow market participants to again return to shorter confirmations (referred to as 'short form confirmations' where the counterparties had already signed the ISDA MA[272]) by utilising standardized sets of definitions for different product categories that could be incorporated into the ISDA MA architecture through reference.[273]

269 Weber (n 118) 807.

270 Eli M Remolona, 'The Recent Growth of Financial Derivative Markets' (Winter 1992–1993) FRBNY Quarterly Review 1, 33–34. <https://fraser.stlouisfedorg/files/docs/publications/frbnyreview/pages/1990-1994/67192_1990-1994.pdf> accessed 1 June 2019.

271 Harding (n 12) 19.

272 ibid.

273 Weber (n 118) 807; Feder (n 35) 352–56. For an overview of the Definitions, Guylaine Charles, 'The ISDA Master Agreement – Part I: Architecture, Risks and Compliance' (2012) January–February, Pract. Compliance & Risk Mgmt 27.

Technological development has also contributed to the evolution of the ISDA MA architecture. In earlier days, automation of the trading process was limited given that there was no technology available to do so.[274] Further along the line, ISDA adopted new technological standards to the ISDA MA architecture introduced first not only by specialized service providers, but also by major dealer banks such as J.P. Morgan. Technological advancement allowed for a quicker and more transparent form of electronic trading. Instead of trade calls, trades were made with on-screen access to bid and ask spreads with added features such as automatic trade execution. The trades were processed in a way that allowed the flow of all trade information to be freely and easily exchanged between counterparties regardless of the software or hardware they were using.[275]

Competition in trading technologies and platforms was a large part of the business already by the late 1980s when 24-hour trading became a reality. Derivatives transactions could be executed in some time zone at any given time through interconnected clearing systems. The more the trades, the easier the trading.[276] It is evident that technological progress has been fast since the 1980s and this progress has raised many questions about ethics and legal standards across different areas of finance. More recently, in the derivatives market, these questions have revolved at least around the question of 'automated illegal activity' of 'autonomous artificial agents' and how to address this plausible problem from a regulatory perspective.[277]

Nowadays, new technologies are commonly referred to as 'FinTech', which is also an umbrella term to describe the emergence of a distinct business sector in financial technology. 'Distributed ledger technology' and 'blockchain' may offer responses to obligatory *trade reporting* of derivative contracts to trade repositories, a legal person that centrally collects and maintains the records of derivatives, for regulatory purposes.[278] Distributed ledger technology may have profound implications also on the OTC derivatives market. At its core, distributed ledger technology has a computer protocol that has various uses across payment systems to financial reporting and compliance, to name only a few areas of application. It can be used to record and share the same information among its users in allegedly more reliable form and

274 Andrew Parry, 'ISDA/FpML for financial derivatives' (2007) 22 J.I.B.L.R. 495, 497.

275 Umberto Cherubini, Giovanni Della Lunga, *Structured Finance: The Object-Oriented Approach* (John Wiley & Sons 2007) 277.

276 Chris O'Malley, *Bonds Without Borders: A History of the Eurobond Market* (John Wiley & Sons, Inc 2014) 171–75. For the impact of technology on the on-exchange futures trading and the emergence of electronic trading platforms, Ray McKenzie, 'The Impact of Electronic Trading on the FX Market' in Francesca Taylor, *Mastering Derivatives Markets: A Step-by-Step Guide to the Products, Applications and Risks* (4th edition, The Mastering Series, FT Press 2011) 215–21.

277 Gregory Scopino, 'Preparing Financial Regulation for the Second Machine Age: The Need for Oversight of Digital Intermediaries in the Futures Markets', (2015) Colum. Bus. L. Rev. 439.

278 Alexis Collomb, Klara Sok, 'Blockchain / Distributed Ledger Technology (DLT): What Impact on the Financial Sector' (2016) 103 Communications & Strategies 93.

manner than is currently possible. Payments and post-trade processing are among the likely areas where this technology can be used, which could mean that existing processes may be enhanced rather replaced by FinTech.[279]

For example, blockchain technology would allow for a greatly enhanced traceability of ownership in securities. On a practical level, the technology could enhance delivery-versus-payment systems in that it would allow buyers and sellers to ensure that the seller is indeed the legal owner of the securities being sold, and the buyer has the cash to buy them. As discussed earlier, settlement times traditionally vary between cash accounts and securities accounts. Distributed ledger technology would treat these account types as the same, or more precisely 'to have on the same digital data infrastructure', which would at least decrease the risk of having two sets of settlements between two account types with different settlement times. Essentially, and in theory, in the blockchain environment a trade would equal settlement, while in the traditional environment trade and settlement are two sets of processes with different legal implications.[280]

Generally, this rapid growth in financial technology may 'increase financial diffusion and industry evolution in a way that strains regulatory supervision and assessment'.[281] While the concepts can be new, rapid technological advancement adopted and driven by the financial sector is by no means a new phenomenon as it can be verified to have been its characteristic feature at least from the 1970s. It would also seem that these new technologies and their implications are not generally well understood and their adoption can give rise to significant legal uncertainty. While international organizations, such as the Committee on Payments and Market Infrastructures that operates under the Bank for International Settlements and IOSCO and regional actors, such as European Securities Market Authority of the EU, have identified and sought to regulate these new areas, it may be that the national legal systems can exacerbate the legal risk as these technologies 'by its very nature, transcends national borders and national legal frameworks'.[282] In other words, transnational law can collide with legislation and regulation. The occurrence and the nature of such an event cannot be forecasted or even quantified with any precision.

The same technology will likely have a significant impact on the financial market infrastructure generally and central counterparties specifically.[283] The centrally stored data is used by regulators such as ESMA, national competent authorities,

279 Imogen Garner and others, 'FinTech: analyzing the changing nature of financial services' (2016) 140 C.O.B. 1, 2.

280 Collomb, Sok (n 278) 6.

281 Christina Parajon Skinner, 'Whistleblowers and Financial Innovation' (2016) 94 N.C.L. Rev. 861, 874.

282 Garner and others (n 279) 6–7, 11–12. For an argument in favour of coordination through standard-setting bodies such as IOSCO, Skinner (n 281) 922–25.

283 There is evidence that the techonology of CCPs are created by the large dealer banks. Paolo Saguato, 'The Ownership of Clearinghouses: When Skin in the Game is not Enough, the Remutualization of Clearinghouses' (2017) 34 Yale J. on Reg. 601, 651–52.

the European Systemic Risk Board, and the central banks of the European System of Central Banks to carry out their supervisory functions of regulatory oversight.[284] For example, such trade datasets have been used in assessing the behaviour of market participants and investors in a market situation involving credit default swap trading and the ISDA Master Agreement and the risk flows in the credit default swap market.[285] The reporting obligation has been welcomed by regulators and academics alike in overcoming certain areas deemed problematic in the OTC derivatives market.[286] However, regulators have also identified and addressed problems associated with the quality and availability of the data in some instances.[287] The impact of such new technologies to trade reporting and financial market infrastructure are outside the scope of this dissertation but it is assumed that this area will be met with regulation and reregulation.[288]

5.10 PRIVATE REGULATORY MECHANISMS: CREDIT DERIVATIVE DETERMINATIONS COMMITTEES

5.10.1 THE ORIGINS AND REVOLUTION OF CREDIT DEFAULT SWAPS

Technological advancement in risk management played an important part in this development as well as they 'enhanced dramatically the perceived ability of large financial institutions to identify and quantify risks, leading to increased confidence in investment and hedging strategies that utilized data from those technologies'.[289] An important example of financial innovation, contractual standardization and yet another rapid market growth can be found from the early credit derivative markets. The first credit default swap[290] has often been attributed to a transaction negotiated and executed in 1994 when JP Morgan, an investment bank, sold its $4.8 billion credit risk exposure towards Exxon, a large oil and gas company, facing a $5 billion law suit from the famous 1989 Exxon Valdez oil spill, to the European Bank of

284 EMIR preamble (5), (41).

285 Grzegorz Halaj, Tuomas A Peltonen, Martin Scheicher, 'How did the Greek credit event impact the credit default swap market? (2018) 35 Journal of Financial Stability, 136, 139; Marco D'Errico, Stefano Battiston, Tuomas A Peltonen, Martin Scheicher, 'How does risk flow in the credit default swap market? (2018) 35 Journal of Financial Stability, 53, 60.

286 Paola Lucantoni, 'Central counterparties and trade repositories in Post-trading infrastructure under EMIR Regulation on OTC derivatives' (2014) 29(11) J.I.B.L.R. 681, discussing the information asymmetries between investors and their intermediaries, 687.

287 Financial Stability Board, 'Review of OTC derivatives market reforms – Effectiveness and broader effects of the reforms' (29 June 2017) 15–18; Ryan J Patrone, 'Linking past and present: assessing the stability of Post-title vii derivatives markets' (2015–2016) 12 N.Y.U. J.L. & Bus. 459, 502.

288 Janet Austin, 'Protecting Market Integrity in an Era of Fragmentation and Cross-border Trading' (2014–2015) 46 Ottawa L. Rev. 25.

289 Weber (n 118) 807.

290 Many others have claimed to have been the first, Taylor (n 276) 228.

Reconstruction and Development (EBRD), a public financial institution established in 1991. EBRD, which had plenty of funds at its disposal, was willing to take this credit risk exposure in exchange for a yearly fee payable by J.P. Morgan.[291] In the simplest of terms, if Exxon would default on its credit line towards JP Morgan, EBRD would cover this loss to the former.

In addition, one important factor for executing this trade was that under the 1988 Basel Capital Accord (Basel I), the minimum capital adequacy requirements in force at that time, J.P. Morgan had to hold certain amount of loan-loss reserves in its own accounts against the risk of non-payment by Exxon. J.P. Morgan could have transferred the actual credit line, the loan, but as by law this would had required permission from Exxon, this was not an option given that it could have damaged the client relationship.[292] In 1996, the Federal Reserve System of the US issued a statement that allowed financial institutions to reduce their regulatory capital requirements by transferring default risk from their balance sheet. By tailoring and structuring a then-exotic CDS with EBRD, J.P. Morgan could transfer the risk and relieve itself from the regulatory burden of holding loan-loss reserves for a risk to which it no longer had exposure.[293]

From the regulatory perspective, CDS contracts remained an anomaly subject to regulatory arbitrage with one main question revolving around whether the credit risk weighting should be about the credit risk in the reference asset, like in the aforementioned credit line between J.P. Morgan and Exxon, or the credit risk of the counterparty.[294] In the EU, from a capital treatment perspective, credit derivatives received lower risk weight under the Solvency Ratio Directive provided that the credit derivative was made for 'hedging purposes'. To prove that it was, market participants were required to provide documentary evidence of a valid transfer of risk to regulators. Regulators in different jurisdictions had different criterias and for this reason, there was no level playing field for financial institutions in this regard.[295]

The market for CDS would grow rapidly during the following years creating an ever-increasing demand for contractual standardization, especially in regard to what event would require the protection seller to compensate the protection

291 O'Malley (n 276) 149–50.

292 Kim (n 19) 347.

293 O'Malley (n 276) 149–50.

294 Burkhard Drees, Garry J Schinasi, Charles Kramer, 'Modern Banking and OTC Derivatives Market: The Transformation of Global Finance and its Implications for Systemic Risk' (2000) 203 Occasional paper/ International Monetary Fund 1, 39–40 <https://www.researchgate.net/profile/Charles_Kramer3/publication/5120149_Modern_Banking_and_OTC_Derivatives_Markets_The_Transformation_of_Global_Finance_and_its_Implications_for_Systemic_Risk/links/0046351797739bac46000000/Modern-Banking-and-OTC-Derivatives-Markets-The-Transformation-of-Global-Finance-and-its-Implications-for-Systemic-Risk.pdf> accessed 1 June 2019.

295 Federico Torzo, Peter Scherer, 'The capital treatment of credit derivatives in Europe' (1999) 14 J.I.B.L. 144, 147–150; Council Directive of 18 December 1989 on a Solvency Ratio 89/647/EEC for Credit Institutions, OJ L386, Council Directive 93/6/EEC of March 15, 1993, [1993] O.J. L141/1.

buyers. The early contractual drafts 'varied widely over a range from reasonably good to embarrassingly bad'.[296] To meet this demand, in 1998 ISDA published a 19-page ISDA Confirmation (Confirmation of OTC Credit Swap Transaction, Single Reference Entity, Non-Sovereign) that could be used either with the ISDA MA or as a standalone contract. Already before its official publication, market participants used the draft versions of the ISDA Confirmation.[297] At that time, the innovation was that credit default swaps could help to achieve at least two central objectives from the perspective of financial institution which were: (i) the possibility to maintain good relationship with a borrower (selling of an asset would require the creditor to notify the borrower that it has transferred the loan to another entity) while; (ii) transferring the exposure, not the asset itself, to a party willing to take the credit risk in exchange for a fee through swap. The counterparties to a CDS transaction do not need, nor are expected to have, any relationship with the reference entity. In contrast to insurance, the parties executing the swap do not need to own the asset and prove a loss when the CDS is contractually triggered, i.e. a situation covered by a contractual term known as 'Credit Event' has occurred.[298]

The innovation that tied the economic substance and legal considerations is that the occurrence of payment obligation depends on how a Credit Event is defined. The ISDA Confirmation included eight standardized definitions which the market participants could use as they saw fit.[299] In addition, given that some of the Credit Events are more or less subjective (for example, default on a loan) whereas others are not (for example, bankruptcy filing date) and thus subject to potential disputes between the protection buyer and the protection seller, ISDA further added specifications beforehand to address this issue.[300] ISDA responded with the first version of standardized terms to this end and introduced the ISDA Credit Derivatives Definitions (1999),[301] now in its 2014 version,[302] which was at least a partial driver for the rapid growth of the emerging credit derivatives market and for the reduction of potential legal disputes, while common, concerning the same.[303] Market participants identified many legal risks in credit derivative trading,

296 Henderson (n 60) para 6.1.

297 For a comprehensive assessment of the range of CDS documentation, Henderson (n 60).

298 Taylor (n 276) 229, 234–35.

299 R Brent Jones, Thomas J Werlen, 'ISDA Offers Standard Documents for Credit Swaps' (1998) 17 Int'l Fin. L. Rev. 21, 23, including a summary of credit events; Taylor (n 276) 227; For the process of how market events affect the definitions and how the amendment process is carried out between market participants, Ed O'Connell, Kristin Boggiano, 'Understanding ISDA's Credit Derivative Rules' (2003) 22 Int'l Fin. L. Rev. 23.

300 Brent Jones, Werlen (n 299) 21, 23.

301 O'Malley (n 276) 152.

302 ISDA news release, February 21, 2014 <https://www.isda.org/2014/06/30/2014-isda-credit-derivatives-definitions> accessed 1 June 2019.

303 Romain G Ranciere, 'Credit Derivatives in Emerging Markets' (2001) IMF Policy Discussion Paper, International Monetary Fund, 4–5, <https://econ-papers.upf.edu/papers/856.pdf> accessed 1 June 2019.

one of which was that the transactions could be recharacterized as insider trading. Through contract standardization and innovation, parties could reduce this risk. The risk was that while being contractually allowed to call default at the point of Credit Event, insider trading laws could see this as insider trading by the buyer, the seller, or the reference entity, if the information allowing for the Credit Event to be 'triggered' was not publicly available on the market. For this reason, ISDA standardized a condition according to which a Credit Event could be 'triggered' only when the information leading to the same was publicly available from sources defined in the contract.[304]

Regarding the question of why regulators failed to regulate the new market in the US, the answer was clear: prohibiting credit derivatives would not have curtailed the market but rather it would had developed outside the US. It was a public policy question of protecting the domestic financial industry from foreign competition in this emerging market.[305] Considering the experiences from the eurobond markets, the argument is understandable. Once the use of credit swaps was allowed, it was no longer a matter of prohibiting the CDS market from emerging, but rather controlling it to the extent possible, perhaps counterintuitively, by not interfering, and by allowing the market to expand within the jurisdiction of the US regulatory agencies. Later amendments to existing laws, relaxation to position limits, and the enactment of new laws further clarified the legal status of OTC derivatives. This culminated in the enactment of the Commodity Futures Modernization Act[306] of 2000 that explicitly prohibited the SEC and CFTC from regulating the OTC derivatives markets. [307]

The Discussion Paper also includes the list of market standard ISDA definitions used in sovereign credit events, 15–6, and an example timeline for physical or cash settlement, 17 < https://econ-papers.upf.edu/papers/856.pdf > accessed 1 June 2019. The standardization process was slow which postponed the adoption of the ISDA MA 2002, Harding (n 12) 381.

304 Andrew Yeung, 'Credit Derivatives: The Art of Splitting Credit Risk' (1999) 15 B.F.L.R. 297 306–09.

305 Anupam Chander, Randall Costa, 'Clearing Credit Default Swaps: A Case Study in Global Legal Convergence' (2010) 10 Chi. J. Int'l L. 639, 659–61.

306 Commodities Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763A (2000) (codified in scattered sections of 7, 11, 12, and 15 U.S.C.).

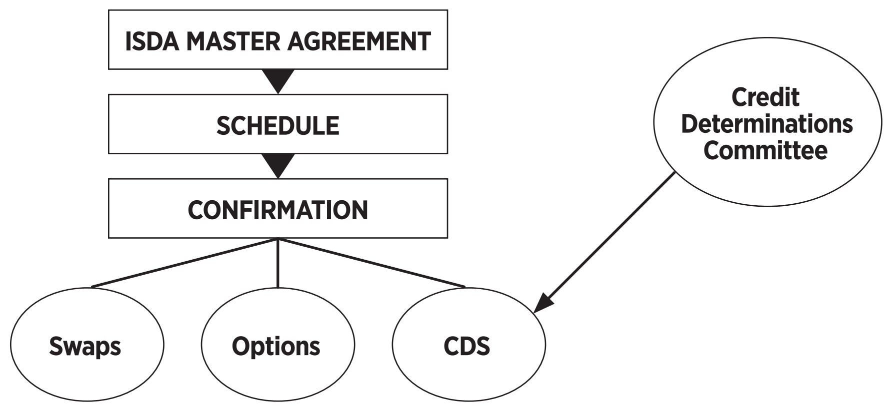
307 Securities Exchange Commission <https://www.sec.gov/spotlight/dodd-frank/derivatives.shtml> accessed 1 June 2019; For a summary of regulatory approach to hedging with credit default swaps, Gina-Gail S Fletcher, 'Hazardous hedging: the (unacknowledged) risks of hedging with credit derivatives' (2013–2014) 33 Rev. Banking & Fin. L. 813, 843–52.

5.10.2 TRANSNATIONAL CDS TRANSACTIONS

Credit derivative may resemble insurance, but unlike in insurances, the protection buyer does not need to prove any loss or have any credit exposure to the reference entity. If credit swaps were to be characterized as insurances while the seller was not an authorized insurer, these products could potentially, if not likely, become unenforceable and their seller potentially subject to sanctions for unauthorized activity. Credit derivatives come in many forms and in economic terms they may be structured as a swap, an option, or their hybrid - swaption, but usually they are executed in the form of a swap. They fall within the ambit of 'derivatives' because credit derivatives derive their value from another instrument or product. [308]

TABLE 3

SINGLE AGREEMENT WITH CDS DEFINITIONS AND THE CREDIT DETERMINATIONS COMMITTEE



The basic idea of *credit default swaps,*[309] needs to be explained in order to understand Credit Determinations Committees, an important evidence of the existence of both transnational law as well as an private regulatory mechanism. Party A (the 'protection buyer') is, for one reason or another, worried about the creditworthiness of Party X (the 'reference entity') which is in financial difficulties. If Party X is unable to perform

308 Henderson (n 60) paras 5.1–5.10; Matthew C Turk, 'The convergence of insurance with banking and securities industries, and the limits of regulatory arbitrage in finance' (2015) 967 Colum. Bus. L. Rev. 967, 1046–1052; Paul U Ali, 'Credit Derivatives and Synthetic Securitizations: Innovation and Fragility' (2005) 20 B.F.L.R. 293; David Benton, Patrick Devine, Philipp Jarvis, 'Credit Derivatives Are Not Insurance Products' (1997) 16 Int'l Fin. L. Rev. 29.

309 Henderson (n 60) describes how '[t]hey [credit derivatives] have been blamed for the credit crunch, with little serious analysis and distressingly ill-informed and misleading public discussion', para 5.1.

(a 'credit event') under its loan agreement (a 'reference obligation'), the credit event might be unfavourable to Party A. For a fee, Party B (the 'protection seller') offers to compensate Party A should the credit event occur.[310] From the perspective of the protection seller, the motive may be in gaining an exposure (expecting, for example, Party X to find a way to conduct profitable business) or simply because Party A is willing a pay for a transfer of a type of risk to which the protection seller could not otherwise gain exposure to. To reduce disputes over its contents, ISDA standardized the aforementioned definitions.[311] The basic terms of a credit default swap contract could include:

- The reference entity, i.e. Party X;
- The reference obligation, for example, a bond issued by a state;
- Credit event, i.e. the circumstances that 'trigger', i.e. give the protection buyer to demand payment or performance from the protection seller. In this case the trigger being the failure of Party X to pay the reference obligation;
- Deliverable obligations, either physical or cash delivery.

Upon a credit event, the protection buyer transfers the reference obligation to the protection seller and receives a par payment from the latter (physical settlement) or, much more commonly, through cash settlement. Cash settlement is conducted in a private auction mechanism developed by ISDA in 2005.[312] The auction will determine the auction settlement price. For example, if the price for the reference obligation is 8.5 cents on the dollar, Party A will receive 91.5 cents from Party B upon the occurrence of a credit event. Only certain market makers, i.e. large transnational dealer banks, are eligible to participate in the auction in which they place their bids on the reference obligation to determine the auction price. Cash settlement is favoured over physical settlement for practical reasons: If many CDS contracts with the same reference entity have been sold and a credit event occurs, a temporal spike in the demand of, and consequently the higher price on, the reference obligation followed by a credit event can be avoided.[313]

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310 Example based on the terminology used in Heinz-Dieter Vogel, Christina E Bannier, Thomas Heidorn, 'Functions and characteristics of corporate and sovereign CDS' (2013). Working Paper Series, Frankfurt School of Finance & Management, No. 203, 10–1 <http://hdl.handle.net/10419/81547> accessed 1 June 2019.

311 Moorad Choudhry, *Structured Credit Products: Credit Derivatives and Synthetic Securitisation* (2nd edition, John Wiley & Sons, Inc 2010) 21–22, 135.

312 Cash settlement became the transnational norm in the aftermath of the GFC. In 2008, Markit Group Limited, a private company, served as the auction administrator who set the specific terms of the auction based on documentation approved by ISDA. Justin Conway, Julia Lu Fu, 'ISDA's evolving auction methodology: cash settlement of loan credit default swaps' (2008) 2 LFMR 495; Taylor (n 283) 233.

313 This is because there may be much more CDS sold than there are actual reference obligations in the market and if the protection buyers have to deliver physically such reference obligations, the prices for that reference obligation can increase greatly, Patrick Augustin, Marti G Subrahmanyam, Dragon Yongjun

5.10.3 TRANSNATIONAL LAW IN ACTION: GREECE SOVEREIGN DEBT DEFAULT REVISITED

The G20 agreed upon a framework of reforms for the OTC derivatives markets in 2009.[314] Transnational private regulation took a large step forward in the same year, but perhaps less visibly, especially with respect to CDS contracts. Among the most notable aspects of a new protocol created under the ISDA MA architecture was the creation of credit derivatives Determinations Committees (DCs). These Determinations Committees 'were an innovative, truly global, private market dispute resolution mechanism for the CDS markets'.[315] It was this particular 'Private Sector Involvement' mechanism created by ISDA, as coined by *Yves Quintin*, that would come to play a decisive role on Greek debt in 2012 discussed below. In Europe, the DC consisted of 15 financial institutions, ten dealer institutions, and five buy-side institutions, from which public officials were excluded. In order to understand the Greek restructuring, it is necessary to know how these private regulatory mechanisms operate.[316]

Credit default swaps are typically executed under the ISDA MA architecture to which market participants have added a separate set of definitions known as the 2003 ISDA Credit Derivative Definitions. Since 1998, ISDA has regularly used a method to address new contractual and legal issues through a private regulatory mechanism known as protocols.[317] ISDA established a protocol known as 'Big Bang Protocol' and 'Small Bang Protocol' in 2009 which introduced the possibility for market participants to request the formation of a determinations committee to adjudicate a wide range of possible issues arising under CDS transactions. The Big Bang also added auction settlement provisions that establish the method for the valuation of the CDS through an auction. In this connection, CDS contracts became more transparent in their pricing, more standardized, and were pushed towards central clearing at the initiative of dealer banks themselves.[318] Both the DC and the auction methodology are governed by a privately-created rulebook known as ISDA Credit Determinations Committees Rules, among other private

Tang, Sarah Qian Wang, 'Credit Default Swaps: A Survey' (2014) 9 Foundations and Trends in Finance, 1, 20–21, <https://ssrn.com/abstract=2532799> accessed 1 June 2019.

314 Chapter 6.

315 Colleen M Baker, 'When Regulators Collide: Financial Market Stability, Systemic Risk, Clearinghouses, and CDs' (2015–2016) 10 Va. L. & Bus. Rev. 343, 371–72.

316 Yves Quintin, 'Alis...da in wonderland or Greek tragedy? the dynamics of credit default swaps and the 'voluntary' Greek debt restructuring of 2011/2012' (2012) Int'l Bus. L.J. 277, 278–81; under the standard CDS documentation, market participants may also choose a law firm to decide whether a Credit Event has occurred or not. Paul N Watterson, Craig Stein, Kristin Boggiano, 'New Bullet LCDS Contract Replaces Cancellable Contract' (2010) 6 Pratt's J. Bankr. L. 327, 331.

317 <https://www.ISDA.org//protocols/protocols–overview> accessed 1 June 2019.

318 Choudhry (n 311) 140–41.

rulebooks.[319] Effectively, a private trade organization has created private regulatory mechanisms that necessarily does not involve *any* lawyers acting in the capacity of a judge or an arbitrator.[320] These private regulatory mechanisms are not even characterized as *dispute* settlement systems in the traditional sense, but as an ad hoc way of dealing with and finding a solution to or a price in certain pretedermined market occurrences. One such event took place when the Hellenic Republic (Greece) were to unilaterally insert retroactively so-called collective action clauses into its national debt instruments governed by Greek law in order to facilitate a restructuring of its public debt. One central question was whether this would constitute a Credit Event under the CDS contracts sold on Greek national debt.[321] While many of the important aspects of the events cannot be revisited in this connection, it is worthwhile to describe how the private regulatory mechanisms involved operate.

Market participants protect themselves from sovereign default and national bailouts of domestic financial institutions by using credit default swaps.[322] If the repayment of a distressed government debt is rescheduled or is otherwise reorganized, it has repercussions on the CDS market where the risk that a sovereign defaults on its debt are bought and sold.[323] The combination of a developed country defaulting on its debt and its repercussions to the second-largest currency in the world, the euro, was 'the largest episode in financial history'.[324] The bondholders of the bonds issued by Greece were represented by a transnational organization, the Institute of International Finance (IIF), which negotiated directly with Greek officials. The largest dealer banks formed, and self appointed an independent steering committee to negotiate with both the IIF and Greece. The steering committee was a market innovation without legal representation or mandate. Its power derived only from the implicit consent of Greece and of the bondholders for this arrangement.[325] In the absence of of other laws or regulations, market participants from the public

319 ibid 392–97; Jacky Kelly, John Goldfinch, 'Weapons of Less Destruction' (2009) 28 Int'l Fin. L. Rev. 36; Kenneth A Kopelman, Stephen C Tirrell, Christine L Ayotte-Brennan, 'The Continuing Evolution of Credit Derivatives: ISDA Publishes 2009 Supplement and Protocol' (2009) 5 Pratt's J. Bankr. L. 319.

320 Conway, Fu (n 312) 495.

321 Following the sovereign debt crisis of eurozone member states at that time, the insertion of collective action clauses was a way to avoid eurozone defaults and facilitate the rescheduling of public debt with private sector bondholders, among others. Allen & Overy Global Law Intelligence Unit, 'Uses and Abuses of Collective Action Clauses in Sovereign Bonds' (2013) 14 Bus. L. Int'l 269, 272; Michael Bradley, Mitu Gulati, 'Collective Action Clauses for the Eurozone: An Empirical Analysis' (March 28, 2013) <https://ssrn.com/abstract=1948534> accessed 1 June 2019.

322 Panayiota Koulafetis, *Modern Credit Risk Management. Theory and Practice* (Macmillan Publishers Ltd 2017) 100–02.

323 ibid 107–09.

324 Philip R Wood, 'How the Greek Debt Reorganisation of 2012 Changed the Rules of Sovereign Insolvency' (2013) 14 Bus. L. Int'l 3, 6.

325 ibid 11–12.

sector and private sector relied on fundamental principles of transnational law and private regulatory mechanisms.

In short, collective action clauses, while common in the terms and conditions of sovereign debt, are something that may be used to amend the existing terms and conditions of the debt instrument to a significant degree by changing: (i) the structure of how the debtors can exercise their voting rights; (ii) their ability to call default and demand premature payment of the bonds; and (iii) how and by whom any payments made by the debtor will be shared among its creditors.[326] In the case of Greece, the first question was how would the collective action clause be used, and second, what would this mean under the terms and conditions of a wholly other financial instrument, credit default swaps that private investors had bought to protect themselves from the default of Greece. More specifically, after much speculation, the question was whether the collective action clause would be used to force the private bondholders to change their existing bonds to new securities issued by Greece *and* would this constitute a Credit Event. If deemed to have occurred, a Credit Event would have caused the sellers of CDS on Greek bonds to pay the CDS buyers. This, in turn, would depend on the interpretation of the ISDA MA definitions regarding the voluntariness or mandatoryness of the Greek restructuring of the bonds. The DC viewed that the bondholders had voluntarily agreed to the reduction in principal and its subordination to bonds held by the ECB. This led to two interlinked consequences. First, buy-side market participants assumed that their CDS contracts on Greece and other countries in financial trouble would turn out to be worthless, if the DC would make the same conclusion in other sovereign bonds. Second, it made it more difficult and more expensive for these countries to raise capital from the market for the same reason.[327]

Many market participants had bought these CDS contracts from certain financial institutions to shield themselves, hedge their position, or to speculate, among other potential reasons, a potential default by Greece. To further complicate the matter, many of these investors were both CDS buyers as well as sovereign bondholders, thus raising questions about potential conflict of interest. In either case, should the actions of Greece constitute a Credit Event under the terms and conditions of the CDS contracts, these protection buyers would be compensated by the protection sellers in exchange for the Greek bonds, i.e. physical delivery. The market value of the bonds had depreciated owing to the inability of Greece to pay its debts.[328]

326 Allen & Overy (n 321) 270–72.

327 Quintin (n 316) 277–78.

328 Apparently, the fear was that since nobody seemed to have a clear picture of who was to pay to whom and how much, the net notional amount of the Greek CDS having been said to be approximatel 3.2 billion of Euros, and would the financial markets come to a halt as a result of credit event further escalating the financial turmoil in a turbulent sovereign debt market in the EU, Quintin (n 316) 278; a study finds that the credit event was well anticipated by market participants, Halaj and others (n 285).

In the Greek case, a private regulatory mechanism, a determinations committee, was required to decide on behalf of its members whether the actions of Greece would constitute a credit event under the terms and conditions of the CDS contracts that would trigger the procedure outlined above. This, in turn, would first depend on how the European Central Bank (ECB) would walk on the tightrope of retaining its own credibility and not breaching its own obligation under its Charter and European Treaties not to bail-out a EU member state unable to repay its debt on the one hand, and on the other, to spare other member states from facing the same situation as Greece. The danger was that a cascade of sovereign defaults might endanger the whole Eurosystem.[329]

After analyzing their options, Greece swapped its existing bonds for seemingly identical bonds with ECB and other bondholders. The ECB received new bonds which were unaffected by the swap in its principal amount and other terms, and the rest of the bondholders were given bonds with reduced principal and other unfavourable terms. As to its economic substance, the swap could have been interepreted to mean that the debt had been restructured. Under the CDS Definition, restructuring would generally constitute a credit event.[330] However, the DC decided that as all creditors had voluntarily agreed to the bond swap, and hence had agreed to receive less than they were entitled to under the original bonds. Following the implementation of collective action clause by Greece through the enactment of a separate law, this policy measure was deemed not constitute a credit event by the DC.[331] Later on, once the ECB had come through the crisis relatively unscathed and maybe the whole Eurosystem project as well, Greece did use collective action clauses in a manner that triggered a credit event. On 9 March 2012, the DC decided that a credit event had occurred under the CDS terms and conditions meaning that the protection sellers had to compensate the protection buyers for the loss in value of Greek bonds[332] and also that a private auction would be held to determine the market value of the CDS pay-out. The auction process was a joint effort of the Determinations Committee, Depository Trust & Clearing Corporation (DTCC), a private financial services company headquartered in New York where the CDS contracts were cleared and settled, as well as Creditex Group Inc., a broker for credit default swaps, and IHS Markit, a service provider for market information and trade

329 Anna Gelpern, Mitu Gulati, 'CDS zombies' (2012) 13 E.B.O.R. 347, 378–80; Rainer Kulms, 'Private creditors and sovereign default: from Argentina to Greece' (2012) Annals Fac. L. Belgrade Int'l Ed 65, 80–84, noting how '[t]he current Greek debt crisis highlights to what extent interference by the IMF or the EU may distort the price mechanism for sovereign bond contracting and restructuring' 84.

330 Quintin (n 316) 287.

331 For a critical view, Quintin (n 316) 282–87.

332 Francesca Villata, 'Remarks on the 2012 Greek sovereign debt restructuring: between choice-of-law agreements and new EU rules on derivative instruments' (2013) 2 Rivista di diritto internazionale privato e processuale 325, 347–48.

processing. From a technical point of view, this particular case was considered to be an achievement in terms of market transparency and efficiency.[333]

To summarize, the case of Greece clearly demonstrates the existence of private regulatory mechanisms and the de facto power they can hold in finance. DCs have a decisive role and control in interpreting the contractual terms of the ISDA MA. The decisions of DCs have a remarkable effect in politically sensitive markets - in this case, maybe to save the CDS market and itself from further sovereign regulatory intrusion.[334] Generally, the benefits of such private settlement mechanisms and processes, such as the DC and auction methodology, do have their positive effects in that they reduce the operational complexity associated with CDS markets, provide market expertise and almost real-time resolution mechanisms, reduce costs of the parties involved by utilizing trading technologies, and enhance the standardization of CDS contracts to fit regulatory frameworks.[335] On the other hand, many questions have been raised. What is the conflict of interest given that the CDS market is in the hands of relatively few market participants who also hold the decisive roles in the DCs? Some of the central questions that private mechanisms raise include: are DCs impartial; do they comply with their own rules; and who supervises them?[336] Post-GFC and due to a regulatory requirement, credit derivatives have generally become more standardized and thus eligible for central clearing. However, while this development is in line with public policy objectives, the very same major dealer banks in this concentrated market have holdings and representation in CCPs, among others, which has given rise to antitrust concerns and even litigation.[337]

Through repeated interactions, market participants can create normative orders with their own private regulatory mechanisms. This is transnational law of finance in action. Transnational method focuses on these interactions and puts them into a legal theoretical structure. Like in the case of bilateral close-out netting, the interests of private market participants and regulators can become aligned and they can converge. The former need legal certainty as to ensure the enforceability of close-out netting in their contracts and the latter need the same for the purposes of maintaining public policy of financial stability. Bilateral close-out netting began as

333 For the Greek CDS Timeline <http://www.dtcc.com/news/2012/june/01/the-greek-cds-timeline-18-days-in-march> accessed 1 June 2019.

334 Gelpern, Gulati (n 329) 389–90.

335 Dan Awrey, 'The Limits of Private Ordering Within Modern Financial Markets' (2014) 34 Rev. Banking & Fin. L. 183, 185–86.

336 ibid 186–87, 219–23; John Biggins, Colin Scott 'Licensing the Gatekeeper? Public Pathways, Social Significance and the ISDA Credit Derivatives Determinations Committees' (2015) 6 TLT 370, 390–92. IOSCO did set up a task force to conduct research and a survey of the market participants relating to the possible conflict of interest issues in the DCs and CDS auction processes, IOSCO, 'IOSCO Statement on the ISDA Credit Derivatives Determinations Committees and CDS auction processes' 10 October 2017 <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD581.pdf> accessed 1 June 2019.

337 Felix B Chang, 'Second-generation monopolization: parallel exclusion in derivatives markets' (2016) Colum. Bus. L. Rev. 657, 672–79.

a spontaneous market practice and gradually evolved into a transnational contract. Following regulatory recognition by international regulatory organizations, this transnational contract further evolved into being virtually mandatory. In time, the enforceability of bilateral close-out netting became codified into the legal orders of many nation states. The ISDA Master Agreement is one manifestation of the *lex mercatoria* of finance. In the aftermath of the global financial crisis of 2008, regulators set their aim towards this contractual architecture.

6. THE REGULATION OF THE OTC DERIVATIVES MARKET AFTER THE GLOBAL FINANCIAL CRISIS

6.1 INTRODUCTION

The bankruptcy of the Herstatt bank in the 1970s (discussed in Chapter 2) left a long regulatory legacy behind it. Financial regulation imposed by international organisations changed the banking industry in many respects, and Herstatt became the starting point of something referred to as transgovernmental financial regulation discussed in this Chapter. In contemporary research, the problems of financial regulation are acknowledged and widely discussed also among legal scholars. However, this does not seem to hinder imposing it. According to *Philip R Wood*, lawyers are the methaphorical priests and the law is the holy word of today.[1] He continues, that '[T]he priests, with their fussy rules about ritual, never approached the triviality of much modern law. The main culprit is regulatory law'[2] which, in turn, is 'almost entirely a 20th century invention'.[3] Of all the types of regulatory regimes, while many of them without a doubt are beneficial, '[p]robably the worst regulatory regime is financial regulation'.[4] So far, the emphasis of this research has been on the description of how finance and law interact. This Chapter offers an example how transnational method may offer an observer the conceptual tools to identify what can happen when states take over a privately regulated area of finance, and what kind of regulatory legacy it can leave behind.

Wood summarizes the problems of regulatory law as follows. First, governmental regulators act both as the agent of the government, the executive, and a judicial tribunal. They reflect a tendency to disregard the separation of powers while contentrating power to the hands of a single governmental body. Second, regulators act both as the judge and the prosecutor, relabel de facto criminal sanctions as administrative penalties, and thus disregard the basic protections of criminal law from those regulated. Third, the rules 'are usually extremely detailed, prescriptive, intricate, and subject to rapid change'. The regulatory codes are 'enormous in size and disproportionate', and the regulators have a tendency to regulate for the sake of regulation. Fourth, these same regulations can be applied extraterritorially with

1 Philip R Wood, The Fall of the Priests and the Rise of the Lawyers (Hart Publishing 2016) 3.

2 ibid 242.

3 ibid 243.

4 ibid 243; *Schuyler Henderson* refers to the regulatory response of the global financial crisis in relation to OTC derivatives as 'a combination of ideology, an old-fashioned political power-grab and cynical manipulation of public opinion', Schuyler Henderson, *Henderson on Derivatives* (2nd edition, LexisNexis 2010) xi.

‘flimsy contacts with the regulating jurisdictions.’[5] As much of this research has touched upon financial regulation, these claims warrant further investigation. Before going into financial regulation of the over-the-counter derivatives market, it is necessary to investigate what is the public policy objective that financial regulation seeks to achieve and that it seeks to prevent.

6.2 FINANCIAL REGULATION AND FINANCIAL BOOMS AND BUSTS

Financial regulatory experts seem to agree that regulating finance is a hard thing to do. Creating regulation may be easy, but does it achieve what it is intended to achieve? As *Frank Partnoy* has summarized:

> [A]lthough there have been hundreds of financial crises, and centuries of research about them, scholars still understand very little about [financial] crises [...] The 2007–08 GFC did not generate much consensus either; instead, created new puzzles.[6]

James R Barth and others share the as Partnoy in admitting how regulating finance is an:

> [e]xtraordinarily hard thing to do. [...] the economic and political ingredients are constantly changing as economies evolve, financiers innovate, lobbyists lobby, and older political constituencies weaken as new ones emerge.[7]

Public policy responses to crisis have been varied in substance and in objectives. The regulatory response to the Global Financial Crisis depends on how one views its origins.[8] For the avoidance of doubt, financial crises are not comparable to natural disasters for which nothing could be done. However, narratives behind public policies go often unchallenged and the ‘symbiotic relations between banks and governments’ are barriers to reforms.[9] The debate over regulation is also polarized.

5 ibid 244.

6 Frank Partnoy, ‘Financial Systems, Crises, and Regulation’ in Niamh Moloney, Eilís Ferran, Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (CUP 2013) 69.

7 James R Barth, Gerard Caprio Jr, Ross Levine, *Guardians of Finance – Making Regulators Work for Us* (The MIT Press 2012) 22.

8 Xavier Freixas, Luc Laeven, José-Luis Peydró, *Systemic Risk, Crises, and Macroprudential Regulation* (MIT Press 2015) 2–3.

9 Anat R Admati, ‘The Compelling Case for Stronger and More Effective Leverage Regulation in Banking’

On one hand, there are those for which everything should be regulated, as it is now, and anything to do with private viewed with outright suspicion. Conversely, there are those who are convinced that regulation may be well-intentioned, but they create adverse unintended consequences that warrant for minimal regulation.[10] Be that as it may, the Herstatt case example discussed in subchapter 2.1.1 demonstrates that complex legal questions can be solved through transnational cooperation between the stakeholders in an orderly manner without virtually *any* financial regulation imposed from top-down. In addition, historical perspective is useful to keep in mind if one is to feed into the blame-game narrative. Certain types of OTC derivative products are attributed as significant catalysts in the global financial crisis of 2008. As the evidence tells, these products, credit derivatives, were not only permitted by regulatory authorities but the structuring of which was originally a joint effort between financial institution and a specialized financing company owned by and operating under the control of states, as discussed in Chapter 5. The use of these credit products was even recommended and incentivized by public regulators, and the source of over-indebtedness and the inevitable creation of toxic assets is at least to some extent a deliberate public policy and political choice emerging from at least from the late-1970s, as discussed in subchapter 2.11.4 and 2.11.5.

Economic boom as a general term is often linked to assumed increased standard of living - built on perhaps unsustainable levels of debt - at artificially low interest rates set by central banks, high returns on leveraged investments fuelled by lax lending practices, infusion of foreign capital pushing the cost of capital even lower, and government policies that may favour all of the above. This is followed by the eventual *economic bust* following the over indebtedness of sovereigns and individuals in relation to their actual net worth when the past performance - built on debt - fails to meet the projections of future performance.

There is nothing new in *boom and bust cycles* and the procyclical nature of banking. Governmental actors seek to address and prevent future bust phases with financial regulation made in haste perhaps to answer a public outrage and claim credit for quick and grandiose regulatory solutions. Some suggest that this is what happened also after the GFC.[11] These regulations, in turn, seek to prevent a type of financial crisis that has just occurred. The problem is that none of the crises are the same. *John C Jr Coffee* has described this type of cycle as a 'Regulatory Sine Curve':

(2014) 43 The Journal of Legal Studies 35, 55–57.

10 Avinash D Persaud, *Reinventing Financial Regulation – A Blueprint for Overcoming Systemic Risk* (Apress 2015) 7.

11 Kenneth M Rosen, 'Cooperation Before Consolidation in Investor Protection' (2015–2016) 90 Tul. L. Rev. 1211, 1221–21; Steven McNamara, 'Financial Markets Uncertainty and the Rawlsian Argument for Central Counterparty Clearing of OTC Derivatives' (2014) 28 Notre Dame J.L. Ethics & Pub. Pol'y 209 <http://scholarship.law.nd.edu/ndjlepp/vol28/iss1/6237> accessed 1 June 2019.

> [(1)] regulatory oversight is never constant but rather increases after a market crash and then wanes as, and to the extent that, society and the market return to normalcy, and (2) the public's passion for reform is short-lived and the support it gives to political entrepreneurs who oppose powerful interest groups on behalf of the public also quickly wanes.[12]

Saul T Omarova notes and summarizes how the post-GFC anti-financial industry sentiment and the denying of the whole concept of self-regulation risks leading to unilateral top-down regulation which is bound to create 'a never-ending spiral of rulemaking and rule evading' in the form of *regulatory arbitrage* discussed in subchapter 3.5.3. A point worth repeating is that financial regulation is also an ideological battleground driven by narratives between proponents of uninhibited self-regulation from government intrusion and those that claim that self-regulation lacks legitimacy and accountability and thus strict government control is the only solution.[13] Often the proponents of different views are not discussing the same topic, or they understand the key concepts differently. One important note is that self-regulation is not deregulation, and promotion of self-regulation is not inherently incompatible from direct government regulation.[14]

Law and economics tell that regulations can have a 'placebo effect'. Like a placebo medicine, financial regulation can work on a patient who believes that a fake-medicine is real and has real effects. To draw an analogue, if people think that a law can produce the outcome it seeks to produce, they act in accordance with the law.[15] However, placebo medicine is not supposed to contain harmful ingredients. The ethical concern is that laws and regulations can create incentives for people to act in a way that people otherwise would not act were they aware of the actual probability and magnitude of risks.[16] Experts in financial regulation are allegedly 'in fact often keen to keep the politics out of their cooperation and "get on with the job" without worrying much about national lobbies, negotiation mandates, and elusive package deals'.[17] Especially in a financial crisis, the public

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12 John C Jr Coffee, 'Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated' (2012) 97 Cornell L. Rev. 1019, 1029–30; Niamh Moloney, 'Resetting the location of regulatory and supervisory control over EU financial markets: lessons from five years on' (2013) 62 Int'l & Comp. L.Q. 955.

13 Saule T Omarova, 'Wall Street as Community of Fate: Toward Financial Industry Self-regulation' (2011) 159 U. Pa. L. Rev. 411, 422–23, <http://scholarship.law.cornell.edu/facpub/1014> accessed 1 June 2019.

14 ibid 424–45.

15 Amitai Aviram, 'The Placebo Effect of Law: Law's Role in Manipulating Perceptions' (2006) 75 George Washington Law Review 54, 101, 138–40; Michael S Kirsch, 'Alternative Sanctions and the Federal Tax Law: Symbols, Shaming, and Social Norm Management as a Substitute for Effective Tax Policy' (2004) 89 Iowa Law Review, 863, discussing the symbolic reassurance of the public through enacting legislation.

16 Amitai Aviram, 'Bias Arbitrage' (2007) 64 Wash. & Lee L. Rev. 789

17 MAP Bovens, 'The Quest for Legitimacy and Accountability in EU Governance' in Paul't Hart, Deirdre Curtin, Mark Bovens, *The Real World of EU Accountability: What Deficit?* (OUP 2010) 19–23.

opinion and perception of legitimacy that these networks have can turn negative. Reinforcement through repetition of positive narratives is a tool used to rebuild public opinion back to positive. In turn, should these 'pathways of legitimation' break down, public opinion can become negative regardless of the actual economic performance of a society.[18]

Typically, financial crises share three characteristics: prolonged downturn in asset prices, declines in output, rise of unemployment, and following from the collapse in tax revenues, the high increase in public debt.[19] The boom, deep depression, and recovery of the economies of Finland and Sweden in 1985–2000 can serve as one example of what is meant by financial boom-bust cycles where the crisis in the financial sector spills over to real economy. These crises coincide with the liberalization era.[20] Finland and Sweden are chosen as a case example since they both faced extensive institutional changes from the middle of the 1980s. Market liberalization was a gradual process both in Sweden and in Finland from 'no liberalization', to 'partial liberalization', and finally to 'full liberalization'.[21] In addition, in a European context, the recessions that followed the boom-phase were particularly severe in these two countries.[22] In finance, the boom-phase meant soaring rates in credit expansion, consumption, investments, and asset prices. In public policy, this meant lax fiscal policies and interest rate policies that sought to defend the pegged exchange rates. Regarding the effect on the real economy, inflation led to a gradual loss of foreign competition to which the answer of central banks was to keep interest rates high.[23] A surge of newly available cheap credit made both consumers and corporations spend more than they otherwise would have.[24] To add further to the crisis, Finland was severely affected by the collapse of exports to the Soviet Union.[25]

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18 Erik Jones, 'Output Legitimacy and the Global Financial Crisis: Perceptions Matter' (2009) 47 CMS 1085, 1097.

19 Carmen Reinhart, Kenneth S Rogoff, 'The Aftermath of Financial Crises' (2009) 99 (2) The American Economic Review 466.

20 Jaakko Kiander, Pentti Vartia, 'Lessons from the crisis in Finland and Sweden in the 1990s' (2011) 38 Empirica 53; For an analysis of the Eurozone crisis Post-GFC, Kaarlo Tuori, Klaus Tuori, *The Eurozone Crisis – A Constitutional Analysis* (CUP 2014) 61–78.

21 Graciela Laura Kaminsky, Sergio L Schmukler, 'Short-Run Pain, Long-Run Gain: Financial Liberalization and Stock Market Cycles' (2008) 12 Review of Finance, Oxford University Press for European Finance Association 253, 287.

22 Lars Jonung, Jaakko Kiander, Pentti Vartia, 'The great financial crisis in Finland and Sweden – The dynamics of boom, bust and recovery, 1985–2000' (2008) 350 Economic Papers, European Commission, December 2008, 3

<http://ec.europa.eu/economy_finance/publications/pages/publication13551_en.pdf> accessed 1 June 2019.

23 Kiander, Vartia (n 20) 53, 54.

24 Jonung and others (n 22) 10–11.

25 Luc Laeven, Fabian Valencia, 'Systemic Banking Crises Database: An Update' (2012) WP/12/163 <https://www.imf.org/external/pubs/ft/wp/2012/wp12163.pdf> accessed 1 June 2019; Luc Laeven, Fabian Valencia, 'Systemic Banking Crises: A New Database' (2008) IMF Working Paper WP/08/224, 39 <https://www.imf.org/external/pubs/ft/wp/2008/wp08224.pdf> accessed 1 June 2019.

During the early phases of the boom period, market liberalization was still partial. Sweden and Finland fully liberated their capital accounts in 1989. As to the differences, Sweden liberated its domestic financial sector fully already in 1985, in comparison to Finland that did the same in 1990. Sweden liberalized its stock markets fully in 1980, and Finland in 1990. Both countries had seemingly developed legal and social institutions, but they did not shield their economies from arguably unexpected and deep economic recession once international interest rates started to increase, output and asset prices collapsed, and the problems led to *contagion* in their respective domestic banking sectors and from there to the real economy. Defaults in the private sector led to contagion of these problems to financial institutions and the respective currencies of Finland and Sweden. While not an isolated issue, the fact that both countries had fixed exchange rates in force amplified the boom period and deepened the economic downturn and made their economic systems vulnerable to speculation on their respective currencies that further exacerbated the situation.[26]

One of the many lessons of the boom-bust cycle in Finland and Sweden is that rapid credit expansion can fuel financial bubbles, and that 'great crises come always as a surprise'. Large institutional shifts can cause economic turmoil in some, but not in other countries with similarly mature markets but with institutional preparedness to address the challenges of an internationally open banking sector that can be very different to a closed national banking sector.[27] More generally, decisions made during a crisis are made under uncertainty, the optimal policy choice amid financial crisis 'is almost impossible', and lessons of the past may not offer much guidance for present or future problems.[28] The debate over financial regulation follows the same cycle in that during a crisis there are strong calls for a complete rehaul of the whole financial system, and once the crisis seems to be over, the debate fades in a matter of months into oblivion.[29] The general lessons are also useful to keep in mind in the design of any financial regulatory system.

26 Jonung and others (n 22) 5–6.

27 Kiander, Vartia (n 20) 53, 55–56, 61–64.

28 Kiander, Vartia (n 20) 53, 67.

29 Persaud (n 10) Appendix A, 'Sending the Herd off the Cliff Edge', 236–37; Gustaf Sjoberg, 'Handling systemically important banks in distress – some thoughts from a Swedish perspective' (2011) 12 E.B.O.R. 227, noting that '[o]ne of the main lessons learned from past Swedish history in this field [bank failures] is to legislate on the basis of experiences of a crisis before it is forgotten' 230.

6.3 RESEARCH ON TRANSGOVERNMENTAL ORGANIZATIONS

Before laying out a working definition of transgovernmental organizations, it is necessary to summarize this research area to avoid unnecessary terminological confusion. Research on transgovernmentalism is about direct and repeated interaction between *state entities* on loosely-structured and unofficial transgovernmental networks.[30] *Janet Austin* refers to these governmental entities as transnational regulatory networks.[31] However, as public regulators ultimately derive their power from nation states, *transgovernmental* might perhaps be more descriptive and clearer since this definition does not include the word 'transnational'. 'Trans', like in transnational law, is also in this context used to describe how something transcends state law and escapes traditional legal categorizations focusing on state-made laws and regulations. In transnational law, is the private normativity created through repeated interactions that espaces the traditional categorizations, and in transgovenrnmental, it is the unclear legal status of state-created organizations that nevertheless play an important role in contemporary financial regulation. Transnational law is here reserved for private normativity and spontaneous emergence of privately created law. 'Transgovernmental' is a term used here to describe semi-autonomous institutions and their horizontally integrated rule-making networks which are de-coupled from states to some immeasurable degree.[32] In other words, research on transgovernmentalism focuses especially on the interactions and cooperation between public or quasi-public regulators that derive their powers from states but not through international treaties under public international law. Transgovernmental studies do not seem to focus on private normativity but maybe they should.

Transgovernmental studies come in different shapes, forms, and names, perhaps understating the importance of private actors in the creation of both public regulation and private self-regulation. In the categorization put forward in subchapter 1.3, transgovernmental studies might be most conveniently seen as part of administrative transnational law that focuses on state actors but where the existence of private normativity is at least acknowledged. For example, *Jan Wouters* and others have noted how '[i]nternational regulatory activity takes place in a great variety of forums and in many different forms, which are often poorly understood,

30 Kal Raustiala, 'Transgovernmental Networks and the Future of International Law' (2002) 43 Va. J. Int'l L. 1, 5; Chris Brummer 'Post-American Securities Regulation' (2010) 98 California Law Review 327.

31 Janet Austin, 'The Power and Influence of IOSCO in Formulating and Enforcing Securities Regulations' (2015) 15 Asper Rev. Int'l Bus. & Trade L. 1.

32 Craig Scott, '"Transnational law" as proto-concept: three conceptions' (2009) 10 German L.J. 859; Neil Craik, Debora Van Nijnatten, '"Bundled" Transgovernmental Networks, Agency Autonomy and Regulatory Cooperation in North America' (2015–2016) 41 N.C. J. Int'l L. 491.

and how 'even private organisations' have contributed to this development.[33] It might be an understatement to say that private actors and organizations have contributed to the development of international regulatory activity as discussed in Chapters 3, 4, and 5. However, while leaving the concept of 'international regulatory activity' open to input also from private organizations, private normativity can be left to the sidelines and viewed with suspicion as is all (too) common. For example, the interests of a trade organization, such as International Swaps and Derivatives Association, Inc. (ISDA), can be seen as directly confrontational with the interests of consumers. The former allegedly weakens consumer protection with strategic 'market protection rhetoric', i.e. in highlighting their own expertise, and 'harmonization rhetoric', i.e. in arguing in favour of industry self-regulation or against tighter local public regulations. It is difficult to draw a direct connection between the OTC derivatives industry, the playground of transnational actors, and private consumers. Nor it is clear what is the connection between consumer protection and the rhetoric used by ISDA when it was lobbying the Russian Federation for the legal enforceability of OTC derivatives as well as legal recognition of bilateral close-out netting and financial collateral in its legal system.[34] To summarise Chapter 5, lobbying has indeed been an important part of reaching legal certainty for bilateral close-out netting in many jurisdictions. Its stated objective was to reduce legal risks, and through risk, systemic risk, that might especially arise from national insolvency laws. It was state organizations that sanctioned and came to require the use of close-out netting provisions in transnational financial contracts which are also used by states themselves.

Trade organizations play an important role in public policy formation and should be understood better. As summarized by *Dan Juma*, the system of international financial regulation is highly complex, over- and underlapping, fragmented universe of actors comprising 'public, private, inter-governmental, nongovernmental and transnational, as well as national actors, each engaged in whole or in part in standard setting, monitoring, cooperation and surveillance'.[35] In his three-part categorization, there are first international financial institutions such as the World Bank and the Bank of International Settlements. Second, there are international standard setting, policy making, and coordination bodies such as the Financial Stability Board and the Basel Committee on Banking Supervision. Third, there are

33 Jan Wouters, Andreas Follesdal, Ramses A Wessel (eds), *Multilevel Regulation and the EU: The Interplay between Global, European, and National Normative Processes* (Brill 2008) 1.

34 Caroline Bradley, 'Financial Trade Associations and Multilevel Regulation' in Jan Wouters and others (n 33) 73, 92–9, 94, n 110.

35 Dan Juma, 'Tempering services liberalization with regulation: The World Trade Organisation and the international financial architecture' (2011) 14 Int'l Trade & Bus. L. Rev. 247, 250–51.

international non-governmental/self-regulatory bodies such as the International Swaps and Derivatives Association, Inc.[36]

To continue with the challenges of public financial regulation, over-eagerness to regulate may come at the expense of the actual effectiveness of regulation. At worst, financial regulation may be fundamentally flawed.[37] Public financial regulation can be un-enforced by the authorities and become outdated dead letters through simple and never-ending market evolution, i.e. technological and legal innovation as discussed in Chapter 3 and 5. It has been long acknowledged that business can be driven by regulatory arbitrage,[38] which, despite its negative connotations, can be seen a feature of modern banking created by financial regulation itself.[39] Furthermore, differences in the underlying assumptions of the public policy objectives behind financial regulation may lead to a serious disagreement between state supervisory agencies themselves that may create additional risks for the financial system.[40] It has also been stated that regulators, claiming to be neutral and in the best position to decide on international regulation, are in fact driven by domestic politics.[41] The public policy objectives that legitimize financial regulation need to be summarized.

6.4 PUBLIC POLICY OBJECTIVES OF FINANCIAL REGULATION

Financial regulation lacks clarity of purpose and priority, and its objectives can be said to be vague, subjective, and even contradictory. [42] What is known and what is important for understanding the nature of finance is that financial instruments can transmit *systemic risk* in the interlinked financial system. It is transnational contracts that interlink different financial markets as is described in Chapters 4 and 5. As noted by *Gregory Shill*, regulators, legal scholars and the market themselves can lack even the vocabulary to describe this phenomenon, let alone having mechanisms to somehow manage it.[43] This is quite worrysome and remarkable at the same

36 ibid 251.

37 Eilís Firan, 'Where in the World is the EU Going?' in Eilís Ferran, Niamh Moloney, Jennifer G Hill, John C Coffee, Jr, *Regulatory Aftermath of the Global Financial Crisis* (CUP 2013) 5–6.

38 Julia Black, 'Paradoxes and Failures: New Governance Techniques and the Financial Crisis' (2012) 75 Mod. L. Rev. 1037, 1044; Subchapter 3.5.3

39 Joseph Tanega, 'Securitisation disclosures and compliance under Basel II: a risk-based approach to economic substance over legal form: Part 1' (2005) 20 J.I.B.L.R. 617, 623; Subchapter 2.1.3.

40 Yulia Guseva, 'Destructive collectivism: Dodd-Frank coordination and clearinghouses' (2015–2016), 37 Cardozo L. Rev. 1693, 1696–1700.

41 Ahmed Sanaa, 'The Politics of Financial Regulation' (2015) 11 Socio-Legal Rev. 61.

42 Jan Dalhuisen, *Dalhuisen on Transnational Comparative, Commercial, Financial and Trade Law Volume 3* (6th edition, Hart Publishing 2016) 492, 499–503.

43 Gregory Shill, 'Boilerplate Shock: Sovereign Debt Contracts as Incubators of Systemic Risk' (2014–2015) 89 Tul. L. Rev. 751, 759.

time given that there has been ample and publicly available evidence at least since the 1960s about these interlinkages discussed under the auspices of transnational law, as discussed in chapter 1, 2, 3, 4 and 5.

What is the public policy, what it aims to achieve, and to who should such mechanisms apply and towards whom, especially considering that every individual regime of transnational private regulation is different, on the transnational plane?[44] What does even 'being accountable' mean besides positively qualifying a given state of affairs or the performance of an actor?[45] No doubt states have the capability to re-regulate private regulatory mechanisms that have 'lifted off' from state legal systems, or perhaps more descriptively have become transnationalised, and which occasionally 'touches down' on state by the seeming necessity to recourse to state law and legal institutions.[46]

Public policy objectives, such as the reduction of systemic risk, enhancement of financial stability, and micro- and macroprudential regulation has been at the centre of the public policy debate since the GFC.[47] Their meaning is obscure. There is a lack of coherence in the very core concepts like 'financial stability',[48] 'systemic risk',[49] and 'macroprudential',[50] which are all referred to in the G20 declaration as something that regulators should focus their efforts on and which serves as a justification for financial regulation. *Hilary Allen* has noted that neither the central international organizations nor local legislations define 'financial stability' although the promotion of financial stability is their shared public policy goal.[51] To add further

44 Deirdre Curtin, Linda Senden, 'Public Accountability of Transnational Private Regulation: Chimera or Reality' (2011) 38 Journal of Law and Society 163, 181.

45 Hart and others (n 17) 33.

46 Robert Wai, 'Transnational Liftoff and juridical touchdown: The Regulatory Function of Private International Law in an Era of Globalization' (2002) 40 Colum. J. Transnationa L. 209.

47 Robert Hockett, 'The macroprudential turn: from institutional 'safety and soundness' to systematic 'financial stability' in financial supervision' (2014–15) 9 Va. L. & Bus. Rev. 201

48 Benjamin Geva, 'Systemic risk and financial stability: the evolving role of the central bank' (2013) 28 J.I.B.L.R;

49 Pawel Smaga, 'The Concept of Systemic Risk' (2014) Systemic Risk

Centre Special Paper No 5, The London School of Economics and Political Science, August 2014 2 <http://eprints.lse.ac.uk/61214/1/sp-5.pdf> accessed 1 June 2019; according to one definition, systemic risk is a combination of an unexpected operational disruption of global finance which translates into a clear and unacceptable threat to the affected political systems clouded by many uncertainties. Allegedly, 'transnational coordination' is still in its infancy. Helmut Willke, Eva Becker, Carla Rostásy, *Systemic Risk. The Myth of Rational Finance and the Crisis of Democracy*, 43, 230 (Campus Verlag 2014); Chapter 5, (n 199).

50 Bezhad Gohari, Karen E Woody, 'The New Global Financial Regulatory Order: Can Macroprudential Regulation Prevent Another Global Financial Disaster?' (2014–2015) 40 J. Corp. L. 403, noting that 'macroprudential policy is decidedly opaque', 409–12; Piet Clement, 'The term "macroprudential": origins and evolution' (2010) BIS Quarterly Review, March; Luc Laeven, Fabian Valencia 'Systemic Banking Crises: A New Database' IMF Working Paper, WP/08/224 < https://www.bis.org/publ/qtrpdf/r_qt1003h.pdf> 409–12.

51 Hilary J Allen, 'What is "financial stability"? The need for some common language in international financial regulation' (2013–2014) 45 Geo. J. Int'l L. 929, 932–935. Allen also suggests the adoption of a wide definition of 'financial stability' that also covers emerging markets in addition to nations with developed financial sectors, 947–48.

legal uncertainty rising from this incoherence, there are considerable cultural differences and divergence in national interests when the authorities exercise their powers under applicable financial regulation. The regulators are unlikely to co-operate due to inherent incentive distortions.[52] Allen continues:

> It is too early to know whether and to what extent the post-crisis reforms to the global financial architecture will work. Measured by its outputs, the modifications appear to be making the financial system safer, but there are, nonetheless, many structural and procedural tensions boiling beneath the surface.[53]

The essence of *micro-prudential supervision*, however, is that it offers a legal frame work for enforceable risk management and capital adequacy rules that should provide a level playing field for market participants. These issues were emphasized earlier in financial regulation, where now it is more about macro-prudential supervision.[54] Microprudential regulation has been said to have failed due to lack of the latter. Macro-prudential focuses on the reduction of systemic risk, among many other widely varying public policy objectives.[55]

6.5 THE NARRATIVE OF UNREGULATED OTC DERIVATIVES MARKET

One characteristic narrative, in addition to the OTC derivatives industry having been *unregulated* or *deregulated* which at least contributed to if not was entirely blame for the Global Financial Crisis of 2007–9 is that regulatory agencies are prone to *regulatory capture*. This refers to a process through which the regulated, transnational financial institutions and transnational corporations, end up controlling the regulatory agencies. Through this process, the regulated themselves play an important role in shaping regulatory networks through lobbying, among others.[56] From a legal perspective, however, when looking at the evolution in the

52 Katia D'hulster, 'Cross Border Banking Supervision: Incentive Conflicts in Supervisory Information Sharing between Home and Host Supervisors' (2011) World Bank Policy Research, Working Paper No. 5871 <http://documents.worldbank.org/curated/en/172321468325263744/text/WPS5871.txt> accessed 1 June 2019.

53 Michael S Barr, 'Who's in charge of global finance?' (2013) 45 Geo. J. Int'l L. 971, 1016.

54 Dalhuisen (n 42) 479–480.

55 Freixas and others (n 8) 493–98.

56 Ernesto Dal Bó, 'Regulatory Capture: A Review' (2006) 22 Oxf. Rev. Econ. Policy 203, 204–07; Barth and others (n 7) 7 referring to literature sources build on 'on the path breaking research by Edward Kane [...] on incentive conflicts in financial regulation', n 13; For incentive conflicts within the financial industry, Jonas Prager, 'The Financial Crisis of 2007/8: Misaligned Incentives, Bank Mismanagement,

over-the-counter derivatives market through legal journals, narratives such as the regulatory capture and monstrously unregulated over-the-counter markets seem quite distant.

Kevin L Young has dubbed this concern as a *transnational regulatory capture narrative* which, while often repeated and assumed to be true, is not always supported by empirical evidence. More often the narrative amounts to unsubstantiated claims suggesting that private sector influence is systematic, consistent, and leads to weakening of regulatory standards.[57] Young claims that much research takes this narrative as given without proper evidence. The problem of many studies is that the underlying assumption is that regulations have been captured while disregarding the variation of how many times transnational lobbyists have actually been successful.[58] Nor was there evidence to be found of regulatory capture in the three case studies of his own. Despite 'transnational private sector lobbying campaigns', also involving ISDA, towards the Basel Committee on Banking Supervision (BCBS) during the design of the Basel II Accord between 1998–2004, the BCBS either refused these arguments (Case study 1: internal credit risk models), adopted much more stringent capital requirements in direct opposition to the claims of the lobbyists (Case Study 2: internal ratings), and adopted stringent regulatory requirements that benefitted some technologically more advanced financial institutions over their competitors (Case study 3: Pillar I capital charge). Followed by this evidence, Young concludes that the BCS uses the private sector information, and engages in direct talks with transnational entities, but it is highly selective and acts as an independent in its decision making.[59] In each case, the BCBS chose the regulatory alternative most opposed by the trade associations. It is Case Study 3 that warrants further investigation. Why would an expert of a private financial institution believe more stringent and costlier regulation is better? Was it a concern over financial stability or something else? The answer might lie in the creation of an additional regulatory cost on purpose when it is relatively cheaper to comply with a regulatory requirement in comparison to competitors. Following this logic, the more intrusive and complex the regulation, the better for some.

Case Study 3 of Young's research suggests that the transnational lobbyists, including ISDA and another trade organization known as the Institute of

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And Troubling Policy Implications' (2012) Department of Economics, New York, <http://ssrn.com/abstract=2094662> accessed 1 June 2019. Prager concludes, 40:

> While misaligned incentives play a dominant role in the minds of economists [...] as appealing as this narrative might be in explaining the financial crisis of 2007–2008 – at best it was supportive rather than primary; Chapter 3 (n 26); Chapter 3 (n 217).

57 Kevin L Young, 'Transnational regulatory capture? An empirical examination of the transnational lobbying of the Basel Committee on Banking Supervision' (2012) 19 4 Review of International Political Economy 663, 666.

58 ibid 667–68.

59 ibid 663.

International Finance (the IIF), launched 'extensive transnational lobbying campaign to oppose the explicit "Pillar 1" capital charge for operational risk' that effectively would require banks to develop internal procedures to manage one particular type of risk. The counterargument of the trade organizations was that this was unnecessary and costly, contrary to industry best practices, and even slowed the innovation of risk management. As is usual, the counterarguments were backed with information-rich industry studies. The IIF even established a separate working group consisting of 40 large transnationally active banks to justify its position. The BCBS did not cave in. What is noteworthy is that the ranks of the IIF began to crumble when an informal group of experts was formed under the IIF that was in favour of the BCBSs' position. This smaller group came from a much more advanced group of 10 transnational financial institutions than the rest of the group in terms of their operational risk management practices. Viewing the regulatory cost as a relative competitive advantage - it would cost more for the smaller competitors to comply with the capital charge - over their competitors, it was in this small groups favour to align with the view of the BCBS, which in turn benefited from the input of an 'impartial' expert group in reaching its regulatory objective. ISDA and the IIF was unable to veto BCBSs' position.[60] Before summarizing the findings of others, it is worthwhile to see what the actual view and regulatory response of those regulated was.

6.6 PRIVATE RESPONSE TO THE GLOBAL FINANCIAL CRISIS

In the aftermath of the GFC, the large dealer banks formed a policy group known as the Counterparty Risk Management Policy Group (the Policy Group) to provide a private sector response to the credit crisis with the stated intention of complementing a similar type of efforts carried out by official bodies by offering a set of policy precepts and recommendations that should be pursued as a package as the viability of one of these recommendations depends on the other.[61] The Report acknowledged that the common interest of mitigating systemic risk should trump the interests of individual institutions while also noting that in a competitive marketplace, the common interest should be pursued collectively rather than voluntarily by individual

60 ibid 677–79; Persaud (n 10) 247–49:

> Complexity is the avenue of capture [...] Big banks can more easily carry the cost of sophisticated internal risk assessment than banks that are small, new, or operating in developing countries [...] Basle II will amplify the credit cycle and add to instability – a particular hardship for small companies and developing economies.

61 The Report of the CRMPG III, 'Containing Systemic Risk: The Road to Reform', August 6, 2008, 15 <http://www.crmpolicygroup.org/docs/CRMPG-III.pdf> accessed 1 June 2019. The Policy Group members are listed in Exhibit I and the members of the Working Groups in Exhibit II.

institutions.[62] The Report stressed that high-risk complex financial instruments should be sold only to sophisticated investors and that the sell-side should ensure that themselves as well as that their counterparties qualify as such.[63] The Report also urged that private initiative should complement official oversight in creating and offering industry-wide practices shared by market participants and that primary supervisory bodies should engage and comment directly their views to the largest market participants in continuous meetings about financial risks and their capability to absorb them if so required.[64]

Many of the recommendations of the Report touch upon the use of the ISDA MA architecture as well as the use of central counterparties which is why they are briefly summarized. The Report stresses the importance of adherence to 'industry standards' and refers to the ISDA Master Agreement in particular, and the role ISDA in achieving many of the recommendations. First, it recommends that dealer institutions should consider limiting their trades with counterparties that do not adhere to standards relating to, among other things, settlement and valuation.[65] Second, the Report urges for the further standardization of the ISDA CSA with the objective of reaching effective dispute resolution provisions for valuations disputes.[66] Third, it calls for active engagement in a technique referred to as 'trade compression' and that 'major market participants to aggressively pursue their use'.[67] Fourth, the Report recommends that auction mechanisms should be incorporated as the market standard mechanism to the ISDA architecture.[68] The report also urges dealers to engage in periodic simulated close-out situations and stress scenarios as well as to identify legal risks that might arise in connection with close-out.[69]

Overall, the Report equates ISDA MA architecture with the concept of market standard. It also reflects, albeit in a transparent and open manner, the viewpoint and interests of its drafters, assumedly the larger dealer banks. However, the Report identifies the asymmetry between sell-side and buy-side and that the latter has concerns about many of the issues recommended in the Report. For example, the Report strongly promotes the use of close-out amount introduced (and discussed in subchapter 5.2.5) in the ISDA MA 2002. This approach gives the non-defaulting party wide discretion in determining the replacement cost of the

62 ibid V–7, 15.

63 ibid V–19–20.

64 ibid V–7–8, 14, 29.

65 ibid V–14, 32

66 ibid V–11, 33

67 ibid V–14. Trade compression is a technique that allows the reduction of the number of trades and total notional amount in central clearing. Jon Gregory, *Central Counterparties – Mandatory Clearing and Bilateral Margin Requirements for OTC Derivatives* (Wiley Finance 2014) 130–31.

68 (n 61) V–16, 34.

69 (n 61) V–18, V–20, 34

terminated transactions as long as the result of the determination is 'commercially reasonable'. As discussed in Chapter 5, it has been most often for courts of either England or the State of New York that will ultimately decide whether the close-out was carried out properly and in accordance with their respective laws. While the Policy Group recommends the wide adoption close-out amount approach (discussed in subchapter 5.2.5), especially among dealers, it also recommends that sell-side and buy-side representatives should form a working group under the auspices of ISDA to address this issue and agree on standardized mechanisms, in a form of best practices or contractually, and reconcile on differing views on the valuation parameters in producing a close-out procedure that would be deemed 'commercially reasonable'.[70]

6.7 OTC DERIVATIVES REGULATION AFTER THE GLOBAL FINANCIAL CRISIS

6.7.1 TRANSGOVERNMENTAL REGULATORS TAKE THE STAGE

According to *Joost Pauwelyn* and others, public international law and formal treaty-making has been increasingly in retreat and has become stagnant at least since the 2000s. Both the number and quality of international treaties has decreased. Instead of treaties that require consent, states rely more on informal law-making because it is perceived as, among other reasons, a more flexible method for cross-border cooperation.[71] Transgovernmentalism has naturally been at the centre of attention also in the post-GFC regulatory environment of the OTC derivatives market.[72] Post-GFC, transgovernmental networks, especially the G20, are the de facto originators of regulation of OTC derivatives trading.[73] The G20 is a global 'club' of 19 economically powerful states and the EU. 'Club' means that the G20 holds no legal foundation, stable procedural rules, nor a permanent secretariat.[74] The history of the meetings dates back to the 1960s when the first informal meeting of the more economically powerful states was held to discuss international financial cooperation. Issues that

70 (n 61) V–18, V–19, 124.

71 Joost Pauwelyn, Ramses A Wessels, Jan Wouters, 'When structures become shackles: stagnation and dynamics in international lawmaking' (2014) 25 Eur. J. Int'l L. 733; Andrew T Guzman, 'The design of international agreements' (2005) 16 E.J.I.L. 579, 591–94.

72 Tessa White, 'From the group of twenty to the group of two: the need for harmonizing derivatives regulation between the United States and the European Union' (2015) 78 Law & Contemp. Probs. 301.

73 Jan Wouters, Sven Van Kerckhoven, Jed Odermatt, 'The EU at the G20 and the G20's Impact on the EU' in Bart Van Vooren, Steven Blockmans, Jan Wouters (eds), *The EU's Role in Global Governance: The Legal Dimension* (OUP 2013) 266–67.

74 Directorate General for Internal Policies Policy Department A: economic and scientific policy, The European Union's Role in International Economic Fora, Paper 1: The G20, 12–13 <http://www.europarl.europa.eu/RegData/etudes/STUD/2015/542207/IPOL_STU(2015)542207_EN.pdf > accessed 1 June 2019.

transcended national borders, transnational that is, were on its agenda from its early beginnings. The G-10, a smaller club of economically powerful nation states, established also the Basel Committee on Banking Supervision (BCBS) in 1974.[75] Due to the informality of these meetings, existing members could invite new members to participate as they saw fit,[76] but during the 1990s broadening the membership base became an issue among its existing members.[77] Following the financial crisis in Asia in 1998 and the GFC in 2008, the G20 further cemented its role in global economic governance.[78]

Today, while the G20 summits have no formal institutional relationship with its ministerial, the latter is likely directed and subordinate to the summits. It employs many other ad hoc bodies and generally, the organizational structure of the G20 is unclear. This club does not sit well with the definition of an 'international organisation' as it is not treaty based under public international law. The definition of organization is itself unclear in this context, and the G20 lacks a separate international legal personality to begin with.[79] For this reason, it is referred to as transgovernmental regulator.

In the context of the regulation of the OTC derivatives market, the G20 is de facto a club of two, the US and the EU. The policy choices they make affect the choices made in 3rd states globally.[80] This is largely because the largest transnational financial institutions are located in the US and in the EU.[81] The EU has considerable representation and voting power over those powerful EU member states that are also members of the G20. The large EU member states represented in the G20 might in turn be inclined to exercise their power over smaller EU member states, which lack representation, via G20.[82] Due to the 'lack of in-house expertise, own financial resources and enforcement capacity, [the G20 is] dependent on the expertise of numerous international organizations and standard-setting bodies to develop and

75 Juha Jokela, 'The G-20: a pathway to effective multilateralism?' EU Institute for security Studies European Union Chaillot Papers, April 2011, 12–13.

76 Peter Holcombe Henley, Niels M Blokker, 'The Group of 20: A Short Legal Anatomy from the Perspective of International Institutional Law' (2013) 14 Melb. J. Int'l L. 550
558–63.

77 Jokela (n 75) 15.

78 Jokela (n 75) 27, 35; transgovernmental organizations can also be categorized as part of *global governance* the meaning of which can be summarized as:

'some kind of an umbrella term for various organised attempts to manage problems that are deemed as global and an effort to achieve coordinated measures in order to accomplish global objectives' in Jaakko Husa, *Advanced Introduction to Law and Globalisation* (Edward Elgar Publishing 2018) 36–37.

79 Henley, Blokker (n 76) 582–87.

80 White (n 72).

81 John Welling, 'In defense of the dealers: why the SEC should allow substituted compliance with the European Union for security-based swap dealers?' (2016–2017) 85 Fordham L. Rev. 909, 939–40, n 283.

82 Wouters and others (n 73) 261.

implement G20 commitments'.[83] While yielding much power, '[t]he G20 does not have a stable legal foundation based on traditional legitimacy concepts'.[84]

The G20 established the Financial Stability Board (FSB) in 2009, the FSB set up a separate OTC Derivatives Working Group in 2010, which in turn published several progress reports on the implementation of OTC derivatives regulations in different jurisdictions.[85] The FSB issues non-binding recommendations, which have been criticized for being too imprecise leading to further problems. Local regulators implement the recommendations in an inconsistent manner, even when they take the recommendations into account in good faith.[86]

According to the Charter of the Financial Stability Board Article 23 the Charter 'is not intended to create any legal rights or obligations'.[87] FSB is said to lack any formal power over its members and, due to the lack of these powers, it focuses on surveillance, peer review, and promotion of international standards.[88] As noted by *Chris Brummer*, The Charter leaves 'little indication of just how the FSB would do its work'. More fundamentally, questions arose as to the legitimacy of the organization, since it was not a formal international organization, and, equally important, not all countries are represented by it.[89] Many other similar organizations, for example, the European Systemic Risk Board (ESRB),[90] and The International Organization of Securities Commission (IOSCO),[91] are the 'coordinators' if not the de facto originators of financial regulation.[92] For example, G20 has delegated responsibilities to IOSCO, the origins of which go back to the 1970s like that of the Basel Committee, which in turn releases soft-law instruments in the form of

83 Directorate General for Internal Policies Policy Department (n 74) 13.

84 Rolf H Weber, 'Legitimacy of the G20 as Global Financial Regulator' Society of International Economic Law, Online Proceedings Working Paper No. 2012/13, 9–10 < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2088315> accessed 1 June 2019.

85 GA Walker, 'International Financial Instability and the Financial Stability Board' Directorate General for Internal Policies Policy Department A: economic and scientific policy (2013) 47 Int'l Law. 1, 24–25, n 207.

86 Kathryn Collard, 'Advantages of a co-regulatory OTC derivatives regime' (2014–2015) 46 Geo. J. Int'l L. 877, 890–901.

87 Charter of the Financial Stability Board <https://www.fsb.org/wp-content/uploads/FSB-Charter-with-revised-Annex-FINAL.pdf> accessed 1 June 2019.

88 Stephany Griffith, Eric Helleiner, Ngaire Woods (eds), 'Special Report – The Financial Stability Board: An Effective Fourth Pillar of Global Economic Governance' (2010) The Centre for International Governance Innovation

<https://www.cigionline.org/sites/default/files/fsb_special_report_2.pdf> accessed 1 June 2019.

89 Chris Brummer, 'Introductory Note to the Financial Stability Board Charter' (2012) 51 Int'l Legal Materials 828.

90 Eilis Ferran, Kern Alexander, 'Can soft law bodies be effective? The special case of the European Systemic Risk Board' (2010) 35 E.L. Rev. 751. The ESRB, established in the aftermath of the GFC, is an expert body without legal personality and with no binding powers, but '[i]n principle the ESRB's lack of formal power need not prevent it from acting in a credible and authoritative manner' 753, 764.

91 IOSCO is also a transgovernmental regulatory body that is not based on a treaty instrument under public international law which renders its legal nature 'quite unclear', Antonio Marcacci 'IOSCO and the spreading of a US-like regulatory philosophy around the world' (2014) 25 E.B.L. Rev. 759, 760–61.

92 Anu Arora, 'The global financial crisis: a new global regulatory order?' (2010) 8 J.B.L. 670, 678–79.

memorandum of understandings and principles accompanied with guidelines to their interpretation. The member states of IOSCO then incorporate these policies into their own laws. The member states will ultimately decide whether to adopt a particular policy as IOSCO cannot force countries to adopt recommendations, by definition.[93]

The emergence of concepts like *informal international lawmaking* process that 'usually occur in a loosely organized network or forum rather than a traditional international organization'[94] outside formal treaties and public international law are common. Deemed too slow and ineffective, states replace formal treaty-making with soft-law, i.e. with 'quasi-legal instruments that have no legal force, such as non-binding resolutions, declarations, and guidelines created by governments and private organizations', which become adopted and followed possibly due to network effects.[95] As discussed, these processes do not take place under public international law. In the context of the EU, such non-binding instruments find their way to supranational level in the form of directives and regulations that in turn are either transposed to national legal orders or are directly applicable in the Member States. This is how the central public regulations in OTC derivatives trading, European Market Infrastructure Regulation (EMIR)[96] and the Dodd-Frank Street Reform and Consumer Protection Act[97] came into fruition, through G20 initiative.

6.7.2 NARRATIVE BEHIND THE TRANSGOVERNMENTAL INTERVENTION

Already at the outset of the GFC, it was apparent that it would require an easily understandable narrative for the public that would warrant for the public regulation of the OTC derivatives market. Choosing one narrative over the other could easily displace a legal scholar to the seat of policy advocate instead of a more neutral observer. According to *Adam J Levitin*, three narratives could be identified after the GFC. First, there was the '*easy money looking for trouble*' narrative, where the combination of low interest rates, surplus investment funds especially from abroad, investors looking for high revenues, especially in the housing market, and the securitization of these assets. Second, there was the *regulatory narrative* or

93 Austin (n 31) 1–4, 14–15.

94 Sanderijn Duquet, Joost Pauwelyn, Ramses A Wessel, Jan Wouters, 'Upholding the rule of law in informal international lawmaking processes' (2014) 6 H.J.R.L. 75, 82. For the concept of 'informal international law making', Joost Pauwelyn 'Informal International Lawmaking: Framing the Concept and Research Questions' in Joost Pauwelyn, Ramses Wessel, Jan Wouters (eds), *Informal International Lawmaking* (OUP 2012) 13.

95 Bryan Druzin, 'Why does Soft Law have any Power anyway?' (2016) Asian Journal of International Law 1.

96 648/2012 Regulation (EU) of 4 July 2012 on OTC derivatives, central counterparties and trade repositories OJ L 201, 27.7.2012, p. 1–59.

97 Pub.L. 111–203, H.R. 4173.

two complementing regulatory narratives, explaining the crisis through ideologically driven policy of deregulation or the poor design of regulation that predisposed regulators to regulatory capture. [98] Third, the '*Frankenstein narrative*' was that the poorly understood financial innovations outran both the market and regulation and these products were connected to the GFC. All of the above can be placed under a more general '*Greed*' narrative that is more general in its application. Levitin concludes his analysis with a statement that analysis of a multi-causal process like the GFC cannot be in an intellectually defensible way explained through any single narrative.[99] Here it is important again to remind, as noted by *Gabriel V Rauterberg* and *Andrew Verstein*, 'Private or poor regulation, however, is not deregulation [...]', and how 'proposals [for new regulation] must be justified as superior to existing regulation rather than simply superior to no regulation'.[100] If anything, the evidence begs the question of who actually captured what.

Arthur E Wilmarth, Jr has described in great detail many of the areas seen as problematic in the banking industry.[101] The industry's legislative efforts to 'undermine Dodd-Frank' are summarized,[102] as are recent financial scandals,[103] 'revolving doors', the growth of the industry, compensation packages, and 'cultural capture'.[104] As to lobbying, Wilmarth notes that the industry helped to elect certain politicians that opposed the Dodd-Frank and refers to a number of financial industry and other magazine articles apparently as an introduction to the topic,[105] as well as in great detail the campaign contributions directed for certain politicians.[106]

In the US, ISDA has required that financial regulators produce stringent cost-benefit analysis on new regulations as is required by the Securities Exchange Act of 1934. The tactic has been used by the industry earlier and in other areas than finance. The problem of this understandable requirement is that it might be more

98 Adam J Levitin, 'The Crisis without a Face: Emerging Narratives of the Financial Crisis' (2009) 63 U. Miami L. Rev. 1002; in contrast, Jonathan Lindenfeld, 'The CFTC's Substituted Compliance Approach: An Attempt to Bring about Global Harmony and Stability in the Derivatives Market' (2015) 14 J. Int'l Bus. & L. 125; Dan Awrey 'Complexity, Innovation, and the Regulation of Modern Financial Markets' (2012) 2 Harv. Bus. L. Rev. 235, 237, n 6, n 7.

99 Adam J Levitin, 'The Crisis without a Face: Emerging Narratives of the Financial Crisis' (2009) 63 U. Miami L. Rev. 999; Prager (n 56).

100 Gabriel V Rauterberg, Andrew Verstein, 'Assessing Transnational Private Regulation of the OTC Derivatives Market: ISDA, the BBA, and the Future of Financial Reform' (2013-2014) Va.J. Int'l L. 9, 17, 30.

101 Arthur E Wilmarth, Jr, 'Turning a blind eye: why Washington keeps giving in to Wall Street' (2012–2013) 81 U. Cin. L. Rev. 1283.

102 ibid 1317–22.

103 ibid 1322–28.

104 ibid 1406–28.

105 ibid n 7, n 8, n 13, n 15. Similarly, Lucy McKinstry, 'Regulating a Global Market: The Extraterritorial Challenge of Dodd-Frank's Margin Requirements for Uncleared OTC Derivatives & A Mutual Recognition Solution', (203) Colum. J. Transnat'l L. 776, 778, n 2.

106 Wilmarth (n 101) 1317.

difficult to calculate the benefits than it is to calculate the costs of a regulation. This might create a systematic bias against governmental regulatory action.[107] The critical counterargument is that the financial industry does not itself perform a reasonable cost-benefit analysis on the benefits of avoiding or mitigating a financial crisis through regulation.[108] It might be that it is because it is impossible to do such a calculation. *Jeffrey N Gordon* summarizes the problem of making cost-benefit analysis in finance as follows:

> [F]or the financial sector, the system that generates costs and benefits is not a natural system but rather a system constructed by the pattern of financial regulation itself and by the subsequent processes of adaptation and regulatory arbitrage. We simply do not have the foresight to forecast how that system will evolve.[109]

Was there justified reasons to oppose public financial regulation on the OTC derivatives market post-GFC? Perhaps not unexpectedly, the major trade organizations thought there were. As summarized by *Lucy McKinstry*, the financial industry:

> [h]ighlighted the practical dangers of divergence, including duplicative registration requirements, potential overlap and conflict in regulatory requirements for market participants in foreign jurisdictions, discriminatory rules against certain foreign participants, as well as more general concerns of protectionism, fragmentation, and regulatory arbitrage.[110]

6.7.3 THE REGULATORY RESPONSE: EMIR AND THE DODD-FRANK

Following the narrative unregulated OTC derivatives markets and that public regulation in the OTC derivatives market is warranted, the Group of Twenty, the G20, gave its famous declaration urging for the regulation of the OTC derivative industry and request for the Financial Stability Board, an international organization operating under the G20, and its members to assess how to do this[111] that led to

107 Howard A Latin, 'Environmental Deregulation and Consumer Decisionmaking under Uncertainty' (1982), 6 Harv. Envtl. L. Rev. 187, 188–89.

108 Wilmarth (n 101) 1308–17.

109 Jeffrey N Gordon, 'The Empty Call for Benefit-Cost Analysis in Financial Regulation' (2014) 43 The Journal of Legal Studies, 351, 352–53.

110 McKinstry (n 105) n 224.

111 G20 Leaders Statement, The Pittsburgh Summit, September 24–25, 2009:

the enactment of the Dodd-Frank,[112] its Title VII or the 'Wall Street Transparency and Accountability Act of 2010' being of particular interest here,[113] in the US, and in the EU, EMIR alongside other less-central regulatory initiatives for the purposes of this research.

In 2013, the CFTC and the European Commission issued a joint statement on how 'the rules in place pursue the same objectives and generate the same outcomes [...] As a result of the joint collaborative effort, in many places, final rules are essentially identical... [...]'.[114] Both the Dodd-Frank and EMIR are notoriously lengthy, complex, and subject to regulatory arbitrage.[115] The regulators soon identified the problems in the cross-border coordination of EMIR and the Dodd-Frank as, although similar, their simultaneous application 'of each other's requirements could lead to conflicts of law, inconsistencies, and legal uncertainty'.[116]

Christian Johnson describes the Dodd-Frank as follows:

> [T]he amount and complexity of rulemaking that has been required of the CFTC and the SEC is both breathtaking and inconceivable. [...] The difficulty in drafting all of the rules and regulations to implement the Dodd-Frank statutory requirements appears to have been poorly understood by policymakers and regulators. [...] The energy required to digest and understand all of this detail and complexity is mind-boggling and suggests that the CFTC may ultimately have entered into an exercise of futility, creating so many requirements and rules that assessing compliance may become impossible. This onslaught of detailed rules and regulations is difficult enough for US swap dealers,

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'[a]ll standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties *by end 2012 at the latest*' 9,

<http://www.g20.utoronto.ca/2009/2009communique0925.html> accessed 1 June 2019 (emphasis added).

112 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, §§ 111–123, 801–814, 124 Stat. 1376, 1393–1412, 1802–22 (2010) (codified as amended in scattered sections of 7 U.S.C., 12 U.S.C., 15 U.S.C.) (Dodd-Frank Act).

113 15 U.S.C. § 8302 (2012).

114 CFTC Release Number 6640–13, 'The European Commission and the CFTC reach a Common Path Forward on Derivatives' July 11, 2013 < https://www.cftc.gov/PressRoom/PressReleases/pr6640-13 > accessed 1 June 2019.

115 Dodd-Frank Act currently runs to 848 pages, and once completed, no one seems to know when this will be, the page amount could be as high as 3 000 pages. The EU rulemaking response, primary and secondary rulemaking aggregated, is likely even higher, Stan Maes, Dimitrios Magos, Miquel de la Mano, 'Bank Structural Reform and Too-big-to-fail' in Andreas Dombret, Patrick S Kenadjian (eds), *Too Big to Fail III: Structural Reform Proposals: Should We Break Up the Banks* (Institute for Law and Finance Series, volume 16, Walter De Gruyter, GmbH, 2015). The relative cost impact of compliance depends on the size of the entity, Kerry G Kounadis, 'Legal and compliance aspects of 'financial regulatory overshooting" on non-financial entities: the case of European Market Infrastructure Regulation', (2015) 30 JIBLR 228; White (n 72) 322–24, arguing in favour of further regulatory harmonization and transgovernmental networks as a way to prevent regulatory arbitrage, 331–32.

116 CFTC (n 114).

> complete with legions of lawyers, compliance officers, and executives, to navigate. It becomes a nightmare for their US customers to understand. One can only imagine how foreign swap dealers and foreign customers must view the Dodd-Frank regulatory reforms.[117]

The Securities Exchange Commission (SEC) itself is a highly complex organization with a staff of over 4000 persons. The SEC routinely interacts with self-regulatory organizations[118] which would suggest that it is not outruled that there have been many opportunities to engage in the type of behavior demonstrated in the case-study of Young discussed in subchapter 6.5 Echoing the findings made by Young, *Yulia Guseva* warns, among many other issues that if those regulated capture the regulators, the Dodd-Frank may serve the purposes of some of the financially strong private entities over their competitors. Information favouring the few may have become integrated into the regulations.[119] Considering the amount and content of regulations alone introduced in the aftermath of the GFC, it will be extremely hard to know if and how and by whose initiative this occurred.

Claims have been made as to the unconstitutionality of the Dodd-Frank in many aspects, including due process, right to contract, and discrimination, to name only a few. As summarized by *Michael IC Nwogugu* the Dodd-Frank 'is not only operationally, politically and economically deficient but also many parts of [Dodd-Frank] are unconstitutional and should be substantially modified'.[120] Unclear regulatory powers may lead to a well-known phenomenon referred to as 'regulatory collisions', or turf wars among regulators. *Colleen M Baker* notes these as the unintended consequences of the post-financial crisis reforms. Apparently, this time the possibility of such a collision is unique in its systemic implications. Regulatory collision can occur in three relations: horizontally between public regulators and among private regulators; between public and private regulatory regimes; and vertically between public regulators that have mandated private market regulators. While perhaps well intentioned, the regulations may very well prove to be a source of now-latent systemic risk, given that the regulatory environment in which both private and public entities operate is 'chaotic'. There are no regulatory mechanisms, while critical, for preventing such regulatory collisions.[121]

117 Christian Johnson, 'Regulatory arbitrage, extraterritorial jurisdiction, and Dodd-Frank: the implications of US global OTC derivative regulation' (2013–14) Nev. L.J. 542, 566–67.

118 Kenneth M Rosen, 'Cooperation before Consolidation in Investor Protection' (2015–2016) 90 Tul. L. Rev. 1211, 1217–18.

119 Guseva (n 40) 1709.

120 Michael IC Nwogugu, 'Un-Constitutionality of the Dodd-Frank Act' (2015) 17 Eur. J.L. Reform 185, 201–211.

121 Colleen M Baker, 'When regulators collide: financial market stability, systemic risk, clearinghouses, and CDS' (2015–2016) 10 Va. L. & Bus. Rev. 343, esp. 346–7, 350, 357. Baker offers three case studies of potential collisions, one between domestic regulators, one between transnational private regulators, and one between private market regulators operating under a public mandate, 362–71, 377–82, 383.

6.7.4 PRIVATE REGULATORY MECHANISM BECOMES MANDATORY: THE CASE OF CENTRAL COUNTERPARTY CLEARING

Central counterparties are a relatively old form of private regulatory mechanism with its own private rules created by private market participants to facilitate trading in financial instruments. While it is not necessary for the purposes of this research to go into detail about central counterparty clearing – OTC derivatives transactions are still bilateral contracts centrally cleared or not – it is worth noting that the ISDA Master Agreement is still in use and forms the contractual architecture both in central counterparty clearing and in non-central counterparty clearing.[122] The difference between the two is essentially about how the OTC derivatives are cleared, bilaterally or multilaterally. Both clearing types have their benefits and downsides.[123] It is worth noting that central counterparties are one type of private normativity and a private regulatory mechanism. Since the GFC, the default management carried out by central counterparties have become perhaps the most important mechanism given their systemic importance to the financial markets. Default management is a complex part of an already complex industry and in many respects, financial regulation in itself can contribute to legal risks.[124] Historically, CCPs have been used first in futures markets but later on generally in exchanges, and post-GFC also in the OTC derivatives markets.[125] There is a long history and experience dating back to at least the end of the 19th century in the US on the important role that central counterparties hold in market turmoil as a private regulatory mechanism to reduce systemic risk and the risk of cascading bank failures through collateral arrangements and mutualization of risk.[126] Development and enforcement of private standards and rules generally and the standardization of contractual terms have also formed a part of central clearing from its modern beginnings.[127]

Stephen J Lubben notes that the most central element of the Dodd-Frank is that standardized OTC derivative trades must be cleared through a central counterparty. However, the Dodd-Frank did not originally make a provision for the failure of a central counterparty that was now required to handle a multi-trillion-dollar OTC derivatives market. He raises the most obvious question that since central counterparty clearing does not make risk disappear, only transforms it, and that

122 Norman Menachem Feder, 'Market in the Remaking: Over-the-Counter Derivatives in a New Age' (2017) 11 Va. L. & Bus. Rev. 309, 309.

123 Gregory (n 67) 36–39.

124 Jo Braithwaite, 'Central Counterparties (CCPs) and the law of default management' (2017) 17 J.C.L.S. 291.

125 Randall S Kroszner, 'Lessons from Financial Crises: The Role of Clearinghouses' (2000) 18(2), Journal of Financial Services Research 157, 162–65.

126 ibid 164, [t]his credit risk structure helps to reduce the likelihood of a failure of one party causing failures among others, thereby addressing public regulators' concerns about ``systemwide" risk.

127 Randall S Kroszner, 'Can the Financial Markets Privately Regulate Risk? The Development of Derivatives Clearinghouses and Recent Over-the-Counter Innovations, Part 2: The Role of Central Banks in Money and Payments Systems' (1999) 31 Journal of Money, Credit and Banking 596, 600.

central counterparties are public companies now handling a multi-trillion OTC derivatives market, is the next bailout going to be that of a central counterparty, and, indirectly, financial institutions?[128] Furthermore, the existence of bailout mechanisms for CCPs with public money could create an incentive for CCPs to 'shirk risk management responsibilities'. The more confident a government bailout, the riskier the behaviour might be. In comparison to futures markets, the OTC derivatives products are more complex, which could further exacerbate the risk of CCP clearing.[129]

From the perspective of regulators, the public policy objective was to strike a balance between containment of financial risk associated especially with credit swaps 'without suffocating the enormous market in such derivatives'.[130] The regulators believe that higher capital requirements and sufficient collateralization and its protection could have prevented or at least reduced the systemic impact that the insolvencies caused to the financial markets in the GFC. Mandatory CCP clearing would offer better risk management procedures in comparison to traditional OTC derivatives trading. In addition, the regulators could drive OTC derivatives trading towards CCP clearing by imposing higher capital charges for non-cleared derivatives. Lastly, mandatory clearing could help to reduce the informational advantage of the large dealers over their smaller rivals. This is because CCP trading is more transparent as CCPs can disclose information on transactions on a daily-basis. CCP clearing also brings the benefit of perhaps more effective default mechanisms. While there were many other reasons, these are the central arguments on why regulators opted for mandatory central counterparty clearing for standardized OTC derivatives.[131]

It has been argued that this policy choice could create a new type of systemic risk. It might have been a better alternative to let the market participants choose whether to clear their products in a central counterparty or not.[132] On the one hand, clearing obligation can be avoided by structuring transactions as more complex than they would have been without financial regulation, and on the other, clearing obligation can lead to further standardization which brings regulatory benefits.[133] There is

128 Stephen J Lubben, 'Failure of the clearinghouse: Dodd-Frank's fatal flaw?' (2015–2016) Va. L. & Bus. Rev., 127, 128, n 7, 131; Christian Chamorro-Courtland, 'The trilliondollar question: can a central bank bail out a central counterparty clearing house which is "too big to fail"?' (2011–2012) 6 Brook. J. Corp. Fin. & Com. L. 433.

129 Ryan J Patrone, 'Linking past and present: assessing the stability of Post-title vii derivatives markets' (2015–2016) 12 N.Y.U. J.L. & Bus. 459, 499–501.

130 Anupam Chander, Randall Costa, 'Clearing Credit Default Swaps: A Case Study in Global Legal Convergence' (2010) 10, Chi. J. Int'l L., 639, 672–73.

131 ibid 673–77; Gregory (n 67) 44–46.

132 Hester Peirce, 'Derivatives clearinghouses: clearing the way to failure' (2015–2016) 64 Clev. St. L. Rev. 589.

133 Ilya Beylin, 'A reassessment of the clearing mandate: how the clearing mandate affects swap trading behavior and the consequences for systemic risk' (2015–2016) 68 Rutgers U.L. Rev. 1143 1151, 1163; Sean J Griffith, 'Substituted Compliance and Systemic Risk: How to Make a Global Market in Derivatives Regulation' (2013–2014) 98 Minn. L. Rev. 1291, 1344–45.

significant variation across jurisdictions in the way assets of customers, i.e. those who have to buy the clearing service from a clearing member, are protected in the event of clearing member default. In addition, at least in the US, those customers who trade in the futures market are in a more vulnerable position in comparison to those in the cleared OTC derivative market.[134] Central counterparties are an example of private normativity, private regulatory mechanisms, and the interactions between finance and law.

6.7.5 LIVING WILLS OF LARGE FINANCIAL INSTITUTIONS

The Dodd-Frank required the larger financial entities (systematically important financial institutions, or SIFIs) to prepare mandatory reorganization and resolution plans to monitor, reduce, or even prevent financial crisis (known as 'living wills'). *Nizan Pakin*'s findings are partially summarized. While the Dodd-Frank required SIFIs to have them, neither the regulations nor legal literature existed regarding what the living wills were supposed to include. Regulatory requirements for real-time databases and simulations to internal guidelines and financial recovery plans started to emerge.[135] As predicting the future is hard, the simulations based on past events are unlikely to protect against future events.[136] The cross-border element in an insolvency event of a financial institution would render the living wills 'unlikely to work in most cases', the failure of a large transnational corporation would further add to this complexity, and on 'top of the cake', there is the increased risk that in an insolvency event, national regulators '*will be primarily focused on protecting their national interests*, a very alarming possibility, as such gamesmanship would have a negative effect on reducing global systemic risk'.[137]

As noted by *Scott Farrell*, in a similar tone, the complexity of the jurisdiction in a cross-border insolvency is one thing, and the lack of logic another, given that in the event of a major failure, the participants affected 'are likely to be systemically important institutions in their home economies as well'.[138] Following the regulatory measures, including the Dodd-Frank, the too-big-to-fail financial institutions became considerably larger and the market much more concentrated

134 Christian Chamorro-Courtland, 'Collateral damage: the legal and regulatory protections for customer margin in the U.S. derivatives markets' (2016) 7 Wm. & Mary Bus. L. Rev.

135 Nizan Pakin, 'The Case Against Dodd-Frank Act's Living Wills: Contingency Planning Following the Financial Crisis' (2013) 9 (1) Berkeley Bus.L.J. 29, 35–36.

136 ibid 75.

137 ibid 80–82 (emphasis added).

138 Scott Farrell, 'Too important to fail: legal complexity in planning for the failure of financial market infrastructure' (2014) 29 J.I.B.L.R. 461, 467.

through industry consolidations[139] as well as due to apparent deregulatory or reregulatory initiatives taken in the US.[140] It was known already at the outset that the regulatory requirements might disproportionately favour large financial institutions.[141] According to *Gary Gorton* and *Andrew Metrick,* the Dodd-Frank does not address the central vulnerabilities in the shadow banking system although some of its elements were at the heart of the GFC. Some central elements were left out of the new regulations and it is uncertain whether any agency has jurisdiction to act over them.[142]

6.7.6 SUBSTITUTED COMPLIANCE AND EQUIVALENCE

The Dodd-Frank was largely criticized from the outset by foreign governments for its real burdens and uncertain benefits.[143] The Dodd-Frank includes a so-called substituted compliance rule. Under this exemption, foreign market participants could comply with Dodd-Frank by complying with their local regulations that are sufficiently equivalent to Dodd-Frank. By 2014, the regulators had not issued exact procedures on how to achieve substituted compliance.[144] In order to be eligible for substituted compliance, market participants needed to qualify as a 'Non-US Person'.[145] Market participants are subject to legal uncertainty as to the applicability of the Dodd-Frank to their operations given the complexity of the calculations required to determine whether they are 'US persons' or 'Non-US Persons'.[146] The CFTC and the SEC adopted different definitions of what constitutes an US person, which in turn might have led market participants to move some of their business elsewhere to other jurisdictions.[147]

139 James Barth, Moutusi Sau, 'The Big Keep Getting Bigger: Too-Big-to-Fail Banks 30 Years Later' (September 24, 2014) <https://ssrn.com/abstract=2510041> accessed 1 June 2019.

140 Freixas and others (n 8) 96.

141 Mariusz Szpringer, Wlodzimierz Szpringer, 'Law and Economics of Central Counterparties (CCP) – Selected Issues of Regulation and Competition Concerning Financial Market Infrastructure' (2016) 27(5) E.B.L.R. 587, 597.

142 Gary Gorton, Andrew Metrick, 'The Federal Reserve and Panic Prevention: The Roles of Financial Regulation and Lender of Last Resort' (2013) 27 The Journal of Economic Perspectives 45, 60.

143 Andrew W Keller, 'Dodd-Frank's Impact on Derivatives Participants in Asia' (2014) 13 Asian Bus. Law. 35, 45–47.

144 ibid 42.

145 Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed Reg. 41,214, 41,217 (July 12, 2012).

146 Keller (n 143) 40.

147 Alexandria Martin, 'The SEC Rule on Derivatives Trading by Foreign Branches of U.S. Banks' (2014–2015) 34 Rev. Banking & Fin. L., 1, 4–10.

In the EU and under EMIR, substituted compliance is known as '*equivalence*'.[148] The application of equivalence rules resulted in further confusion among market participants as to what rules are applicable or not to their operations. Without legal certainty, the provisions could mean that market participants would have to comply with both the US and the EU regulatory regimes.[149] *Mauricia Salazar* concludes that while the implementation of cross-border recognition rules is a good idea the 'lack of details fails to promote the G20's goals', and that both the CFTC and the European Securities Market Authority (ESMA) 'have provided a false sense of security for market participants-when in fact more due diligence on behalf of market participants is currently needed to properly comply'. As to further consolidation among regulators, Salazar points out that 'one sole governing body that oversees the entire global OTC derivative market is a ludicrous and certainly improbable solution'.[150] It is hard to disagree with this statement. Even if the rules were the same, there would be the issue of divergence in the enforcement of these rules among different regulators. In other words, it is not enough to have substituted compliance in place if the level of enforcement of these regulations differs between jurisdictions.[151]

The idea of 'equivalence' and 'mutual recognition' has a long problematic history beyond EMIR and Dodd-Frank. Within the EU, 'equivalence' is known as 'mutual recognition' which essentially means giving effect to home jurisdiction regulation in the host jurisdiction. For example, a financial institution that has its place of incorporation in one EU member state would only have to comply with the rules of this member state even if the financial institution has operations in other EU member states. Originally in the mid-1980s, equivalence was based on minimum harmonization, home country supervision, and complementary host country supervision.[152] Once it had become clear that EU member states intentionally stimulated regulatory arbitrage themselves by not, for example, supervizing their national industries prudently in accordance with the EU rules, the Commission pursued more regulatory harmonization. In the financial sector, this policy objective was pursued with the so-called Lamfalussy process in 2001.[153] Post- GFC, the harmonization objective was further pursued with the so-called de Larosiere Report

148 EMIR Article 13(2).

149 Levon Garslian, 'Towards a universal model regulatory framework for derivatives: Post-crisis conclusions from the United States and the European Union' (2015–2016) 37 U. Pa. J. Int'l L. 941, 1013.

150 Mauricia Salazar, 'Swapping more than regulations: reexamining the goals of the Dodd-Frank Act and the European market infrastructure regulation on Over-the-Counter derivative markets' (2014–2015) 21 Sw. J. Int'l L. 217, 228–35.

151 Welling (n 81) 941–42, arguing that there exists a political and economic pressure to ensure equivalent enforcement in the US and the EU.

152 Commission White Paper on Completing the Internal Market, COM (1985) 310 final (June 14, 1985) 27–29.

153 Chapter 5, n 133.

in 2009.[154] However, national financial supervisors are still national in character. Regulatory fragmentation 'provides incentives to national financial supervisors to compete via lax supervisory standards and practices'.[155] This deficiency in the regulatory framework is to be overcome with more supervisory cooperation, regulatory convergence, and collaborative mechanisms. These measures include, among others, a new memorandum of understanding, new colleges and networks of financial supervisors, and 'reflexive governance [...] that promotes learning from diversity'. These objectives are to be reached in cooperation with transgovernmental organizations such as the FSB.[156]

While the Dodd-Frank and EMIR are similar in many respects as they are based on the same G20 declaration, they are in many respects different on key issues. In his comparative analysis between the Dodd-Frank and EMIR, *Levon Garlsian* notes that one out of many issues that could undermine the effectiveness of the Dodd-Frank and EMIR, and the 'substituted compliance' and 'equivalence', is that these two regulations define 'derivative' in a completely different manner which 'inevitably leads to further distinctions in the overall derivatives market regulation'.[157] Without being able to identify the regulatory rationale, Garslian notes that the definition of 'derivative' already divides the regulatory powers in the US, where the SEC, which is the regulatory agency in charge of regulating 'security-based swaps' and CFTC, which in turn is charge of regulating 'swaps'. The definitions are 'remote from the standard market and finance practices'.[158] In the US, the regulatory powers between the CFTC and SEC are unclear.[159] Both agencies have the authority to grant further guidance as to what constitutes 'substituted compliance'. CFTC issued one interpretive Guidance in 2012,[160] which the agency has subsequently amended several times. By 2016, the CFTC had not published a final rule on the matter. The SEC publishes its own rules on 'security-based swaps'.[161]

Are things clearer on the other side of the Atlantic in terms of legal certainty or the lack thereof? On 14 February 2014, roughly one and a half years after the entry into force of EMIR, and over thirty years after the emergence of the OTC derivatives market as discussed in Chapter 5, ESMA approached the European Commission

154 Christopher P Buttigieg, 'Governance of securities regulation and supervision: quo vadis Europa?' (2014–2015) 21 Colum. J. Eur. L. 411, 421–24.

155 ibid 425–29.

156 ibid 434–45. For reflexive governance, Olivier De Schutter, Jacques Lenoble (eds), *Reflexive Governance: Redefining the Public Interest in a Pluralistic World* (Hart Publishing 2010).

157 Garslian (n 149) 989.

158 Garslian (n 149) 990.

159 Keller (n 143) 37–38.

160 Cross-border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed Reg. 41, 214 (July 12, 2012).

161 Garslian (n 149), 1010–11.

by a letter drawing attention to 'an issue that could have a significant detrimental effect on the consistent application of' EMIR'. The main issue was:

> The different transpositions of MiFID across Member States mean that there is no single, commonly adopted definition of derivative or derivative contract in the European Union, thus preventing the convergent application of EMIR.[162]

In its response, while not addressing the central question put forward by ESMA, the Commission put forth an argument that further regulations, definitions, and guidelines were warranted under the then upcoming MiFID II Directive.[163] MiFID I, the Directive that includes the definition of a derivative,[164] was the outcome of a highly politicized process.[165] Already at the time of this process, Europe's financial centres were 'being flooded by directives from Brussels' leading to 'regulatory fatigue' often without legal certainty. In 2007, there was a clear demand for regulators to 'settle the ambiguities by agreeing on [MiFID] definitions - and rapidly'. [166]

A brief analysis suggests that if the understanding of 'derivative' was unclear after the transposition of MiFID I, it is unclear after the transposition of MiFID II. A side-by-side comparison of MiFD I and MiFID II, Annex I, Section C, (4)-(10), the section where the definition of derivative is to be found, reveals that the only changes to the definition financial instrument in regards to derivatives was that one part of a sentence was put into parenthesis, (4) and (5); a reference to organized trading facilities was included and deletion of 'wholesale energy products traded on an OTF that must be physically settled' from the definition of one type of commodity derivatives (6); a typological change and deleting one part of the definition of commodity derivative that read 'a having regard to whether, inter alia, they are cleared and settled through recognized clearing houses or are subject to

162 ESMA/2014/184 <https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-184_letter_to_commissioner_barnier_-_classification_of_financal_instruments.pdf> accessed 1 June 2019.

163 Markt/G3/PO/or/(2014) s. 510569, <https://www.esma.europa.eu/sites/default/files/library/2015/11/ares2014513399_ec_response_on_classification_of_financial_instruments.pdf> accessed 1 June 2019. There is an EU plan 'to build a true single market for capital in the EU by 2019'. Niamh Moloney notes that the 'massive and novel' transparency regime for bond derivatives markets 'is likely [...] to have far-reaching and unforeseen effects on market liquidity across a range of asset classes' and that despite new administrative actions of and rules set by ESMA, '[t]he effects of the new regime cannot be reliably quantified in advance'. Niamh Moloney, 'Capital markets union: "ever closer union" for the EU financial system?' (2016) 41 E.L. Rev. 307, 327.

164 Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJ L 145.

165 Guido Ferrarini, Niamh Moloney, 'Reshaping Order Execution in the EU and the Role of Interest Groups: From MiFID I to MiFID II' (2012) 13 E.B.O.R. 557, 564–65.

166 Nathalie Aubry, Michael McKee, 'MiFID: where did it come from, where is it taking us?' (2007) 22 J.I.B.L.R. 177, 181–84.

regular margin calls' (7); deletion of one part of the definition of derivatives relating to 'economic statistics' (10); and inclusion of emission allowances to the definition of a financial instrument (11).[167]

The legal uncertainties have repercussions far outside the US and the EU. The Dodd-Frank and EMIR have 'extraordinary jurisdictional reach over any transaction that involves a US or EU entity'. The benefits of this reach are unclear unlike its negative effects.[168] More generally, '[c]onsidering the complex and dynamic nature of the financial system, regulators' efforts to prevent the next financial crisis will likely be in vain'.[169] The same applies to EMIR. ESMA had not by 2016 issued final rules on the extraterritorial scope of EMIR, only guidance drafts. [170] As summarized by *Jeremmy Okonjo* from the viewpoint of emerging markets, the extraterritorial reach of the EMIR is bound to conflict with emerging market securities laws. The EU's impact assessment[171] does not even address the problem of conflict between EMIR and third country legislation, the duplication and conflict of regulations will be 'detrimental to developing OTC derivatives markets', can undermine the sovereignty of third countries, the equivalence rules of EMIR do little to mitigate this problem, and overall, it does not satisfy proportionality doctrine.[172] Furthermore Okonjo notes that the cost of compliance is asymmetrical, disfavouring market participants in the emerging markets. He raises the question of whether the regulatory costs are proportionate to its perceived benefits, and ultimately suggests that they are not.[173] The compliance costs could act as a deterrent for market participants, and this was not addressed in the regulatory assessment of the EU. Justifiably worrying that the compliance costs could reduce the capital flows to emerging markets and affect their developing OTC derivatives markets, he concludes that '[i]t is unlikely that the US and EU would take into account third-country concerns, as both jurisdictions are accountable to their respective domestic constituencies only'. [174] Now, the OTC derivatives market are publicly regulated.

167 MiFID I, Annex I, Section C; MIFID II, Annex I, Section C.

168 Garslian (n 149) 1012.

169 Keller (n 143) 37.

170 Garslian (n 149) 1009–11.

171 Commission staff working document, Impact Assessment, COM (2010) 484 final.

172 Jeremmy Okonjo, 'Assessing the Impact of the Extraterritorial Provisions of the European Markets Infrastructure Regulation (EMIR) on Emerging Economies' OTC Derivatives Markets: A Doctrine of Proportionality Perspective Challenges and Unresolved Issues' (2015) 7 Indian J. Int'l Econ. L., 1, 36–8, n 9.

173 ibid 38–40.

174 ibid 43.

7. CONCLUSIONS AND REFLECTIONS

7.1 WHAT IS TRANSNATIONAL LAW?

Transnational law is law and it can be studied with a transnational legal method. Transnational method helps to identify and name private normativity that transcends the boundaries of states and existing categories of law. In this research, transnational law was constructed as a transnational legal order, a structure that offers a mental map for answering the question of what transnational law is. The finding is that studying law from thi s perspective is not first and foremost a normative statement that would seek to contradict or to challenge the supremacy of state law but to complement existing categorizations of legal research that focuses on state-made law. Of course, transnational method produces scientific results which in turn can be used to shape public policies. Transnational method focuses on and emphasizes private normativity as a potential source of law. In this research, the decisive qualification has been the enforceability of norms arising from private normativity in the eyes of the state. This method tells that market practices can evolve and through interactions, find their way into state-made legislation. Private normativity and the normative order can further be constructed to a form of a transnational legal order which helps to identify and categorize transnational phenomena. These types of legal theoretical constructs originate at least from the 1960s. Transnational method has a long intellectual tradition and it offers a sound theoretical framework for studying private normativity, private regulatory mechanisms, and bottom-up law-making processes and their interactions with states.

Transnational law was and is also a descriptive umbrella term. Under the umbrella term, one can describe, criticize, theorize, and conceptualize phenomena in a scholarly manner that makes the cumulation of knowledge possible. The observable elements of transnational law, such as transnational contracts, remain in existence regardless of the legal theoretical perspective of the observer. It could be that transnational method is the only legal theoretical method that captures the ontology of private normativity since 'black-letter' law tells little about their origins and how transnational law operates. Pinpointing the private origins of normativity and calling the processes that lead to the emergence of transnational law does not in any way insulate the phenomena from criticism. Quite the contrary, it is essential that the ontology of what is being criticized is first understood to the extent possible.

Regardless of the type of occurrence, from natural disasters to financial crises, that has repercussions on any given financial market, it is often reflected in a transnational contract in which it finds a contractual solution to an unexpected event. Significant market events can even lead to the formation of private regulatory mechanisms, as it happened in the credit default swap market where private credit determinations committees hold exclusive power over the interpretation of the transnational contractual terms. Such private regulatory mechnanisms can and have played a decisive role in the largest financial turmoil that was witnessed in the debt crisis of the Hellenic Republic in 2012. These private rules and normativities are a manifestation of *the lex mercatoria of finance*. From a transnational standpoint, state legislation, financial regulation, and transnational law are in constant interaction with each other. What court praxis indicates is that when transnational law and state law clash, for example, the local public policy reflected in legislation somehow interferes with the contractual intent of the contracting parties, state law holds supremacy over transnational law. The interaction between financial regulation and transnational law is much more difficult to analyse. It has become even more difficult during an era of transgovernmental financial regulation. Nevertheless, financial regulation is a driver for the emergence of transnational law and financial and legal engineering, which, in turn, have a long history of eroding the practical significance of local legislation and financial regulation, such as exchange controls.

In this research, much of transnational law is about the interactions between private normativity and financial regulation. In this respect, the interactions between private trade organizations, such as the International Swaps and Derivatives Association, Inc., and international regulators, such as the Basel Committee are particularly interesting. More currently, quasi-public organizations, referred to as transgovernmental organizations, that derive their existence from the Group of 20 (G-20), a club of economically powerful nations, should be of particular research interest. The regulations deriving from the G-20 have been much criticized in legal literature and can give rise to legal risks which in turn can turn into systemic risk. Generally, financial regulation might almost reflect systemic thinking, leading to path dependence, where the first reaction, almost like a reflex, is to control through regulation and regulate from top-down in greatest of detail every aspect of finance even when, and although, the outcomes of interference can be unknown. Transgovernmental regulation led to divergence in the OTC derivatives market in that these regulations are in any case applied locally by local financial regulators. The public policy objectives of maintaining financial stability and reducing systemic risk are ambiguous concepts.

7.2 TRANSNATIONAL LAW IN PRACTICE

The emergence of the eurobond market as well as the OTC derivatives market can be explained by applying transnational legal method. This method offers a theoretical framework that is capable of identifying supply and demand for financial and legal innovation, the facilitative role some states played in enhancing private normativity, private regulatory mechanism, and the transnationalisation of law. What transnational law theory can suggest is that the emergence of the eurobond market in the 1960s was not the outcome of top-down public policy seeking to transnationalise finance. Rather, it was the outcome of bottom-up law-making spontaneously created by various market participants. The transnationalisation process of eurobonds and the eurodollar market began autonomously from states out of supply and demand for US dollars. States were involved in these repeated interactions, but more in the capacity of facilitators or market participants rather than as regulators. The financial markets during the 1960s were tightly regulated as well as restrictive and could be characterized as even outright hostile towards the free movement of capital. The US policy makers of that time saw the outflow of US dollars as a public policy problem, in terms of US balance of payments, and sought to curb this development through taxation.

Within a few years, structures for repatriation of US dollars back to the US were facilitated through offshore financial centres. The promotion of free capital flows was not on the agenda after the Second World War but to the contrary, these flows were to be regulated locally by nation states as well as by the emerging international organizations. Yet, the eurobond market and subsequently the eurocurrency market not only flourished but evolved at a rapid pace because market participants saw a need to raise capital from the international bond markets as well as for exchanging foreign currencies. This market created a demand for legal certainty which could be found through financial and legal engineering. It would be decades later when these transnationalised markets would become subject to renationalization through directives, like in the EU. The legal orders, reflecting the codification ethos of the 19^{th} century, of the EEC member states are riddled with legal and regulatory obstacles rendering the free movement of capital subject to many forms of control and legal uncertainties.

Under exchange controls, free movement of capital was forbidden without the prior approval of local central banks directly or indirectly through the use of other administrative obstacles, often in the form of mandatory charges, fees, or taxes that made foreign investing more unattractive than investing locally. However, even when the progress towards free movement of capital was gradual, the seeming paradox is that the 1960s and 1970s were also the decades when the largest debt equity market in the world emerged, surged, and served as the base structure of rapid expansion of transnational banking. The OTC derivatives trading, as a form of private normativity through repeated interactions, soon eroded the practical relevance of then existing financial regulations at least in the US and gave rise to a new type of financial regulation that facilitated further transnationalisation of finance. Post the global financial crisis of 2008, the outcome of the interactions between transnational law and financial regulation are largely unknown. Given the fact that booms and bust phases are inherent in finance and that the regulatory responses address and can only address past problems, it is only a question of time when the next financial crisis occurs. The regulatory framework might have become much riskier given its opacity when compared to the transnational insolvency of the Herstatt bank in the 1970s where the legal challenge was overcome not through regulation but negotiation between the parties concerned. While past events do not tell about the future, it can be assumed that once the next financial crisis hits, it will only lead to a similar regulatory reaction as it has so far which, in turn, can potentially be used for the benefit of some market participants over the other.

7.3 SOURCES OF TRANSNATIONAL LAW OF FINANCE

Transnational law can be found in 'black-letter' from transnational contracts and court praxis concerning the same. In the OTC derivatives market, market participants often rely on and favour the expertise of courts and the legal certainty provided by their legal systems. Market participants favour English-American common law for historical and practical reasons as well as for the simple reason that major transnational financial institutions hold a strong presence in England and the US. The reason for this is also historical, since it was England that originally offered the favourable regulatory environment - in relative terms - for the eurobond market.

Transnational law can also be found from state-enacted legislation. It is a demonstrable fact that much of the legislation currently in force in the EU member states concerning the enforceability of bilateral close-out netting originates from private normativity and market practices which can be said to have evolved into transnational customary law already in the 1980s. However, the facilitative role that states have played in recognizing and in providing legal certainty for transnational law has also led to fragmentation and legal risks through renationalization of finance. This is the case, for example, for the exchange of financial collateral where legal risks are prevalent also in part because of financial regulation that may not reflect actual market practices.

In the OTC derivatives market, market participants often rely on and favour the expertise of courts and the legal certainty provided by their legal systems. This is true also in complex transactions where some courts and national legal orders apparently can provide more legal certainty in comparison to other jurisdictions or other forms of dispute resolution. The popularity of English law cannot be explained that English courts would somehow directly apply and enforce market practices and would thus 'rubber stamp' transnational law over national legislation. Rather, the relationship between market participants and the courts, and respectively transnational law and national law, is best characterized as a form of interaction. English courts observe industry practices in their interpretation and application of the national law and, in turn, market participants amend transnational contracts accordingly.

Cases and court rulings concerning transnational contracts are followed very closely by the industry practitioners. Trading can be negatively affected by many unforeseen events. For this reason, transnational contracts include terms and conditions that could be characterized as private regulatory mechanisms. In the case of divergence between commercial perceptions of market participants and the English courts, ISDA can amend the terms of the standardized ISDA Master Agreement architecture, as can the market participants themselves in their respective transactions. Many laws have been amended to facilitate trading in the financial sector, including the OTC derivatives market. Through standardization, transaction lawyers have developed a shared language as early as the 1980s, if not much earlier. The usual structure of a transaction has involved and continues to involve more or less the same legal questions, especially regarding the enforceability of financial contracts in and out of counterparty insolvency.

7.4 REFLECTIONS

A functional rather than formal understanding of 'law' is required to ensure that private normativity is recognized, and its ontology is properly understood. Transnationalisation can be also described as a form of evolution and also through the concept of path-dependence which has many descriptive uses in and outside law. Given its spontaneous ontology and pragmatic solution-based approach across millions of individual transactions, individual cases and fact patterns do not *necessarily* interact well with codified, territorial, and monopolistic state law and financial regulation that divides international flows of capital into separate pieces across jurisdictional lines. Much of the work of lawyers involves ensuring strict compliance with state laws. From time to time, financial transactions do end up in a dispute and if they are not solved in private negotiations, market participants will have to seek remedies from courts. Alternatively, market participants can rely on private regulatory mechanisms to settle various questions.

If transnational law cannot even be conceptualized, then neither can the potential problems associated with it. Those shunning the proponents of the concepts used in this research, from modern lex mercatoria to transnational law as a manifestation of private normativity, for challenging the exclusivity of state when it comes to law creation are unknowingly the best and first line of defence for those who might enjoy and reap the benefits of unjust transnational laws. If private normativity and spontaneous norm creation is disregarded or mischaracterized, the whole scholarly discussion on transnational law can be led far away from the academic roots which were and are about acknowledging private normativity and the evolutionary aspects of law. The cumulation of knowledge can become very challenging if transnational law is seen as an ideological battleground. Fortunately, misleading narratives redefining trasnnational law as something else can be identified with relative ease once their existence is acknowledged.

All market participants, from individual consumers to states, from startups to large transnational corporations, operate in an environment that is unpredictable. Risk is at the core of any profit seeking. The members of different communities adapt to their environment and create laws that shield them and the trade itself from at least those risks that are identifiable and controllable. Whereas states engage in black-letter law making, private market participants form trade organizations and private regulatory mechanisms. States can be a risk not only to market participants but on a systemic scale to the whole financial system. This is especially the case when it comes to financial regulation, the objectives of which are generally cloudy. Nevertheless, finance, through repeated interactions and innovations, tends to evolve over its legal and regulatory frameworks.

After the Second World War, the world saw the emergence of transnational corporations and financial institutions operating in their own transnational sphere fuelled first by eurobonds and subsequently by eurodollars. This development was spontaneous in that the actions were controlled and directed internally by autonomous actors. The literary evidence suggests that eurobonds were not issued to engage in politics nor to engage in academic debate over what is transnational law. They did so to finance their operations, whatever it was for any given actor. Transnational law was and is about legal scholars identifying such issues. It is questionable whether academic or political debate of that time concerning the transnationalisation of business and finance had any impact on this development. Market participants were and are in the market to raise capital for their respective businesses where and how they saw/see fit to produce products or services, whatever they were/are, for which there was/is apparently a market demand. If national laws and regulations were an obstacle, they could be rendered inapplicable by financial and legal innovation. State laws can be also facilitative, and when they are, market activity has a tendency of moving to such jurisdictions. The driver behind this is legal certainty rather than the absence of or laxity of legislation and regulations. To typify financial and legal engineering as something outright illegal, or at the very least socially harmful, can easily lead scholarly analysis astray. This is problematic since attempts to limit transnationalisation processes locally backfire easily in a transnational financial market. It is important that neither practicing lawyers nor legal scholars handicap themselves by adhering to overly-simplistic narratives.

We do not have a foresight on evolution. Transnationalisation of eurobonds in the 1960s was a spontaneous development, together with at least some coordinated planning and gradual institutionalization, but also a sum of coincidents. So was the birth of international financial regulation in the aftermath of the bankruptcy of Herstastt bank in the 1970s and transgovernmental regulation post global financial crisis of 2008. Interactions are constantly in motion, and no one can predict the future. No one predicted the rise of eurobond and eurodollar markets in the 1960s or the OTC derivatives market decades later in the 1980s. No one can predict the impact of distributed ledger technologies in finance now. No one can predict the technologies that do not exist yet and their impact on financial stability, whatever its meaning. The spontaneous emergence of new techniques, revived old techniques, and the following spontaneous norm creation is inherent in human action. When private normativity needs to be critically assessed, and in the author's view should be subject to the most critical assessment, like any other source of power, the substantive autonomy and power, if any, of different stake holders vis-à-vis other stake holders in the private rule-making process is the relevant question to be asked – not whether transnational law is 'law' or not.

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